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No.

In the
Supreme Court of the United States

HCA INC. & SUBSIDIARIES, SUCCESSOR TO
HOSPITAL CORPORATION OF AMERICA & SUBSIDIARIES,
PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether, despite this Court's and other Circuits' consistent application of the factors articulated in *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979), to determine whether an interpretive Treasury regulation sets forth a reasonable interpretation of the Internal Revenue Code, the Sixth Circuit may refuse to consider those factors in its *Chevron* analysis.

2. Whether, regardless of the appropriate standard of deference, the Sixth Circuit erred in upholding an interpretive Treasury regulation that required Petitioners to accrue as income 80% of the receivables that their experience showed they would never collect, when 26 U.S.C. § 448(d)(5) prohibited the Secretary of the Treasury from requiring taxpayers "to accrue *any portion* of such amounts which (on the basis of experience) will not be collected." (Emphasis added.)

LIST OF PARTIES

Petitioners are HCA Inc. and its subsidiaries. Respondent is the Commissioner of Internal Revenue. This case was styled *Hospital Corporation of America & Subsidiaries v. Commissioner of Internal Revenue* in the United States Court of Appeals for the Sixth Circuit and in the United States Tax Court.

RULE 29.6 STATEMENT

Petitioners were members of a consolidated group of taxpayers whose parent was Hospital Corporation of America at the time they filed tax returns for the years at issue. Hospital Corporation of America was merged into another member of the consolidated group in 1994. The parent of the consolidated group is now HCA Inc., which is a publicly owned corporation. No publicly held company owns 10% or more of HCA Inc.'s stock.

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The Tax Court's opinion (Pet. App. 21a-62a) is published at 107 T.C. 116. The Sixth Circuit's opinion (Pet. App. 1a-20a) is published at 348 F.3d 136.

JURISDICTION

The Sixth Circuit entered judgment on October 30, 2003, and denied the petition for rehearing and rehearing *en banc* on February 17, 2004. Pet. App. 63a-64a. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The Appendix (Pet. App. 65a-83a) reproduces the versions of Internal Revenue Code § 448(d)(5) and Treasury Regulation §1.448-2T at issue in this case.[1]

STATEMENT OF THE CASE

This case arises from four events. First, Congress prohibited the Department of the Treasury (the "Treasury") from requiring taxpayers to include in income amounts that their experience showed they would not collect. Second, the Treasury ignored Congress and adopted a mandatory formula that requires many taxpayers, including Petitioners, to include in income amounts that the Treasury and taxpayers know from experience taxpayers will never collect. Third, Petitioners declined to use that mandatory formula because it would have required them to accrue in income 80% of the receivables their experience indicated they would never collect, and instead used a methodology that

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[1] Unless otherwise stated, this Petition and the Sixth Circuit's and the Tax Court's opinions refer to statutory and regulatory provisions in the Internal Revenue Code of 1986, as amended, and its underlying regulations, as in effect during the time periods at issue.

accurately reflected their bad-debt experience. Fourth, the Sixth Circuit—applying its rubber-stamp form of *Chevron*[2] deference—affirmed the Treasury's mandatory formula as a reasonable interpretation of the statute despite its inconsistency with the statute's plain text. Moreover, consistent with Sixth Circuit precedent, the Court of Appeals ignored this Court's teaching in *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979), that the manner in which an interpretive Treasury regulation is promulgated, its consistency over time, and Congress's reaction to it must be evaluated in deciding whether to afford it controlling deference. The Sixth Circuit's refusal to consider the factors articulated in *National Muffler* and its progeny in evaluating the reasonableness of the Treasury's interpretive regulation led to a ruling palpably inconsistent with Congress's intent and contrary to the result that would have been obtained in other Courts of Appeals.

1. **Congress Prohibited The Treasury From Requiring Service Providers To Accrue Any Portion Of Amounts That Their Experience Indicated They Would Not Collect.**

For many years, section 166(c) of the Internal Revenue Code (26 U.S.C. §§ 1 *et seq.*) (the "I.R.C." or the "Code") provided that, in lieu of waiting to take a deduction until a debt became worthless, a taxpayer using an accrual method of accounting could establish a reserve reflecting the total amount of year-end receivables estimated to be uncollectible and annually deduct a reasonable addition to that reserve. Most taxpayers using the reserve method, including Petitioners, estimated their uncollectible receivables using a formula that was first approved in

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[2] *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

Black Motor Co. v. Comm'r, 41 B.T.A. 300 (1940), *aff'd on other grounds*, 125 F.2d 977 (6th Cir. 1942), and was thereafter consistently approved by other courts, the Internal Revenue Service (the "IRS" or the "Service"), and ultimately this Court. *See Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 548 (1979); Rev. Rul. 76-362, 1976-2 C.B. 45.

Under the *Black Motor* formula, the portion of year-end receivables that would not be collected was estimated by multiplying the amount of such receivables by the ratio of average bad debt write-offs (adjusted for recoveries) for the current year and the immediately preceding five years to the average year-end receivables for the same six-year period. Although this was the most widely used methodology for determining a taxpayer's bad debt experience, both the Supreme Court and the Commissioner of Internal Revenue (the "Commissioner") recognized that use of the *Black Motor* formula was not mandatory, as it could in some cases produce unreasonable results. *See Thor Power Tool Co.*, 439 U.S. at 549; Rev. Rul. 76-362, 1976-2 C.B. at 46. In those cases, the formula's result could be adjusted to produce a reasonable outcome. *See* Pet. App. 11a (citing *Thor Power Tool Co.*, 439 U.S. at 549).

In the Tax Reform Act of 1986, Congress repealed the bad debt reserve method of I.R.C. § 166(c) but recognized that this repeal could distort the annual income for service providers, such as Petitioners. *See* Staff of the Joint Committee on Taxation, 99th Cong., *General Explanation of the Tax Reform Act of 1986* 475 (Comm. Print 1987). Congress addressed that concern by enacting I.R.C. § 448(d)(5), which directed the Treasury as follows:

> Special rule for services—In the case of any person using an accrual method of accounting with respect to amounts to be

> received from the performance of services by such person, such person *shall not be required to accrue any portion* of such amounts which (*on the basis of experience*) will not be collected ....

(Emphasis added.) This manner of accounting for amounts estimated to be uncollectible is referred to as the "nonaccrual-experience method."

2. The Treasury Nonetheless Adopted A Mandatory Formula That Required Taxpayers To Accrue Amounts That, Based On Experience, Would Never Be Collected.

On June 12, 1987, the Treasury promulgated under its general rulemaking authority (I.R.C. § 7805(a)) a proposed and temporary interpretive regulation (Temp. Treas. Reg. § 1.448-2T (1987) (the "Original Regulation")), which required all taxpayers to use the *Black Motor* formula (the "Original Formula") to estimate the amount of receivables they would not collect and therefore would not have to accrue as income under the nonaccrual-experience method. *See* 52 Fed. Reg. 22,764 (June 16, 1987); 52 Fed. Reg. 22,795 (June 16, 1987). Contrary to its prior practice under *Black Motor*, however, the Treasury forced all taxpayers to use the Original Formula, regardless of whether it produced reasonable results in their case.

The Original Formula accurately predicted bad debts for most taxpayers, who review and write off their receivables only after a substantial period of collection effort. *See generally Thor Power Tool Co.*, 439 U.S. at 548 n.28. The Treasury learned, however, that application of the Original Formula without the possibility of adjustments produced inflated bad debt estimates for taxpayers with very short collection periods (specifically,

taxpayers in the utility industry). *See Practitioners Say Proposed Ratio for Bad Debts Does Not Reflect Experience,* Daily Tax Rep. (BNA) No. 232, at G-3, G-4 (Dec. 2, 1988) (summarizing remarks of Thomas Evans, Associate Tax Legislative Counsel, Department of the Treasury).

To correct this problem, on April 14, 1988—only ten months after promulgating the Original Regulation—the Treasury issued a revised proposed and temporary interpretive Treas. Reg. § 1.448-2T (the "Revised Regulation"). The Revised Regulation replaced the mandatory Original Formula with a new mandatory formula (the "Revised Formula"). *See* 53 Fed. Reg. 12,513 (Apr. 15, 1988); 53 Fed. Reg. 12,534 (Apr. 15, 1988).

Under the Revised Formula, a taxpayer determines the ratio of its average bad debts written off (net of recoveries) during the current year and the immediately preceding five years to its average *total annual charges* (*i.e.*, total receivables arising in a year) for the same period. But instead of applying the resulting percentage to the taxpayer's total annual charges, the percentage is applied to the taxpayer's *current year-end receivables.* Treas. Reg. § 1.448-2T(e)(2). (The Original Formula, in contrast, compares average write-off history to *average year-end receivables* and then applies that ratio to the *current year-end receivables.*) Like the Original Regulation, the Revised Regulation was promulgated under I.R.C. § 7805(a) without prior notice and comment. *See* 53 Fed. Reg. 12,534 (requesting comments only after the regulations were already effective).

When issuing the Revised Regulation, the Treasury made no finding that the Revised Formula would accurately reflect the experience of most taxpayers. Nor did the Treasury explain why, in the face of I.R.C. § 448(d)(5), it believed it had the authority to force all

taxpayers to use a mandatory formula regardless of whether that formula comported with their actual experience.

After it was issued, the Revised Formula was heavily criticized because it produces absurd results for most service providers, other than those in the utility industry. *See* Roy E. Strowd, Jr., *Nonaccrual-Experience Method of Accounting Causes Confusion and Concern*, 20 Tax Advisor 487, 488 (July 1989); *Practitioners Say Proposed Ratio for Bad Debts Does Not Reflect Experience*, Daily Tax Rep. (BNA) No. 232, at G-3, G-4 (Dec. 2, 1988); *Accountants and Treasury Debate Nonaccrual Experience Method*, 88 Tax Notes Today 242-3 (Dec. 2, 1988).

The most glaring problem with the Revised Formula is that it uses annual charges (instead of year-end receivables) to determine the portion of year-end receivables that will not be collected. As a matter of basic math, a ratio comparing bad debt write-offs to total annual charges will indicate the portion of annual charges that will not be collected, but it will not measure the portion of year-end receivables that will not be collected. The Revised Formula predictably produces an artificially low estimate of uncollectible year-end receivables, because year-end receivables will almost always contain a substantially larger percentage of uncollectible accounts than will total annual charges. *See* Final Brief of the Appellant ("Pet. Brief") at 22, *Hospital Corp. of Am. v. Comm'r*, 348 F.3d 136 (6th Cir. 2003) (No. 01-1810).

The Treasury entertained comments *after* the Revised Regulation was made effective. These comments demonstrated that the Revised Formula produces inaccurate results. The Treasury has never disputed that fact. Indeed, the Treasury recognized the Revised

Formula's weaknesses[3] and consequently kept the nonaccrual-experience method regulation project on its business plan for many years thereafter.[4] Yet the Treasury never amended the Revised Regulation to address its acknowledged deficiencies and never finalized it. Instead, the Treasury enforced the concededly defective Revised Regulation for fifteen years.

In 2002, Congress took the unusual step of expressly directing the Treasury to replace the flawed Revised Regulation.[5] I.R.C. § 448(d)(5)(C) directed the Treasury to

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[3] *See Accountants and Treasury Debate Nonaccrual Experience Method, supra* (response of Thomas Evans, Associate Tax Legislative Counsel, Department of the Treasury, to criticisms of the Revised Formula, stating that the Treasury was open to suggestions and was "'interested in a result that is fair. We're not trying to grab money here.'"); *Practitioners Say Proposed Ratio for Bad Debts Does Not Reflect Experience, supra* (Evans' indication that "Treasury and IRS would be open to suggestions from practitioners [and] ... one approach Treasury is 'thinking about' is to subtract delinquent accounts receivables from year-end receivables before applying the proposed bad debt ratio."); Roy E. Strowd, Jr., *Nonaccrual-Experience Method of Accounting Causes Confusion and Concern, supra* ("[I]t appears that the IRS recognizes that the current calculations may require revision and has identified an alternative that could be both administratively acceptable and reasonably accurate.").

[4] 60 Fed. Reg. 23,845, 23,855 (May 8, 1995) (withdrawing without explanation, as of March 24, 1995, a regulation project entitled "Nonaccrual-Experience Method of Accounting—Clarification of Amounts Determined to Be Uncollectible," which was first included on its business plan in 1988).

[5] The House Report reflects Congress's dissatisfaction with the Revised Regulation:

> [T]he Committee believes that the formula contained in Temp. Reg. section 1.448-2T may not clearly reflect the amount of income that, based on experience, will not be collected for many qualified services providers, especially for those where significant time elapses between the rendering of the

issue a corrected regulation that would permit each taxpayer to calculate bad debt expense "using computations or formulas which, based on experience, accurately reflect the amount of income that will not be collected *by such person.*" I.R.C. § 448(d)(5)(C) (emphasis added). Rejecting the Treasury's one-formula-fits-all scheme, Congress ordered the Treasury to permit every taxpayer to "adopt, or request consent of the Secretary to change to, a computation or formula that *clearly reflects the taxpayer's experience.*" *Id.* (emphasis added).

3. Petitioners Declined To Use The Treasury's Flawed Formula And Instead Used A Formula That Accurately Reflected Their Bad-Debt Experience.

Petitioners own and operate hospitals and outpatient surgery centers and also manage similar facilities for others. Like other healthcare companies, Petitioners experience substantial delays in collecting patient accounts receivable and suffer substantial bad debts.

Before the repeal of I.R.C. § 166(c) in 1986, Petitioners used the bad debt reserve method and calculated their annual reserve additions using the *Black Motor* formula—

> service and a final determination that the account will not be collected. Providers of qualified services should not be subject to a formula that requires the payments of taxes on receivables that will not be collected.

H.R. Rep. No. 107-251 (2001), *reprinted in* 201 Daily Tax Rep. (BNA) S-19, S-37 (Oct. 19, 2001 Text Supp.). The Joint Committee on Taxation's report on the 2002 statutory amendment echoed that concern, noting that "[p]roviders of qualified services should not be subject to a formula that requires the payments of taxes on receivables that will not be collected." Staff of the Joint Committee on Taxation, 107th Cong., *General Explanation of Tax Legislation Enacted in the 107th Congress* 241 (Comm. Print 2003).

an approach accepted by the Commissioner on audit. After 1986, Petitioners elected to utilize the nonaccrual-experience method. Because the Revised Formula did not accurately reflect their experience, Petitioners used the Original Formula (which was based on the *Black Motor* formula) to estimate their uncollectible receivables.

The Treasury has never disputed that the Revised Formula grossly understates Petitioners' bad debt exclusion. The Revised Formula would have excluded from income only 4% of Petitioners' year-end receivables, even though Petitioners' experience was that approximately 20% of such receivables would not be collected. *See* Pet. Brief at 16. These points were uncontroverted at trial. Yet despite I.R.C. § 448(d)(5)(A)'s explicit command that service providers "shall not be required to accrue *any portion* of such amounts which (on the basis of experience) will not be collected" (emphasis added), the Commissioner demanded that Petitioners use the Revised Formula and accrue as income 80% of the receivables that Petitioners' experience indicated they would never collect.

4. The Sixth Circuit, Rejecting This Court's Teaching And The Overwhelming Practice Of The Other Courts Of Appeals, Held That The Treasury's Revised Formula Reflected A Reasonable Interpretation Of I.R.C. § 448(d)(5).

Petitioners challenged the application of the Revised Regulation to their 1987 and 1988 tax years in the United States Tax Court. In ruling for the Commissioner, the Tax Court acknowledged that the Original Formula was "perhaps even a better choice" for Petitioners than the Revised Formula, Pet. App. 52a, but nonetheless upheld the mandatory application of the Revised Formula in deference to the Treasury.

The Sixth Circuit affirmed the Tax Court's decision on appeal. Under *Chevron's* first step (*i.e.*, determining whether Congress has spoken directly on the question at issue), the Court of Appeals found I.R.C. § 448(d)(5) ambiguous because it did not prescribe the use of a particular formula. Instead, the statute "merely used the words 'basis of experience' without delineating what experience was intended." Pet. App. 13a. The Court did not say what alternative experience (other than the taxpayer's relevant experience) could have been intended. Indeed, the Court confirmed its understanding that "[t]he statute provides that a taxpayer shall not be required to accrue amounts that, based *on the taxpayer's experience,* will not be collected." Pet. App. 14a (emphasis added).[6] Yet, without explaining how the phrase "basis of experience" was ambiguous, the Sixth Circuit found it so and held that the Treasury was entitled to define the phrase.

Turning then to *Chevron* step two, the Sixth Circuit found that the Treasury "did not act in an unreasonable or arbitrary manner" when it required all taxpayers to use the Revised Formula to calculate their experience-based accruals regardless of whether the Revised Formula accurately reflected their bad-debt experience. The Court never explained how a mandatory formula that requires taxpayers to accrue most of the receivables that they will not collect could reflect a reasonable interpretation of a statutory text that prohibits the

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[6] The government also acknowledged that "Section 448(d)(5) provides that the exclusion from income be computed *'on the basis of experience' of a particular taxpayer ....*" Final Brief of the Appellee ("Gov't Brief") at 21, *Hospital Corp. of Am. v. Comm'r,* 348 F.3d 136 (6th Cir. 2003) (No. 01-1810) (emphasis added); *see also id.* at 30 ("It is obvious that a taxpayer's actual past experience should be considered in reaching the exclusion amount ....").

Treasury from requiring taxpayers to accrue "*any portion* of such amounts which (on the basis of experience) will not be collected." I.R.C. § 448(d)(5)(A) (emphasis added).

Ignoring that glaring problem, the Sixth Circuit noted summarily that its decision was grounded in the statute's legislative history. The Court had earlier observed that the legislative history of I.R.C. § 448(d)(5) actually articulated two different formulas while purporting to describe one, but the Court made no effort to make sense of that confusion. Instead, it peremptorily concluded that "[t]he Secretary did not act in an unreasonable or arbitrary manner by employing a formula from the legislative history that he thought would effectuate the statutory mandate." Pet. App. 16a.

Pursuant to the Sixth Circuit's long-standing refusal to consider the other factors that this Court and eight other Courts of Appeals evaluate in determining whether interpretive Treasury regulations are reasonable, the Sixth Circuit ignored Petitioners' arguments based on those factors. In this regard, the Court did not even advert to (much less address) Petitioners' contentions that the Revised Regulation does not merit controlling deference because it was not a substantially contemporaneous construction of section 448(d)(5), represented a change in position, was issued without prior notice and comment (and without citation of any good cause for rejecting that procedure), and was expressly disapproved by a congressional amendment to the statute.

REASONS FOR GRANTING THE WRIT

This case presents an issue of doctrinal and practical importance that has divided appellate courts endeavoring to review interpretive Treasury regulations under this Court's decision in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

It is settled law that courts are to review agency rulemakings using the *Chevron* analysis. Yet, a clear conflict persists among the Circuits as to how to apply *Chevron* to interpretive Treasury regulations issued under I.R.C. § 7805(a). This Court has consistently used the factors it articulated in *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979)—which include whether the interpretation was contemporaneous with the statute, has been followed consistently, and was impliedly approved by Congress in later reenactments—to assess, under *Chevron* step two, the reasonableness of these regulations. Every Court of Appeals—except the Sixth Circuit—that has addressed the standard of deference to be given interpretive Treasury regulations has followed this Court's lead in using the *National Muffler* factors. The Sixth Circuit has squarely rejected this Court's approach and that of eight other Circuits by refusing to look beyond the face of the regulation when determining its persuasive force. The rule of law adopted by the Sixth Circuit permits it to avoid the more searching analysis required by this Court and instead approve the Treasury's interpretive regulations after only a cursory examination.

The consistent application of *Chevron* to the Treasury's interpretive rules is a matter of exceptional importance, as application of the regulations that tax the nation's people and industries should not depend, as it did here, on the taxpayer's venue. This Court's intervention is necessary to resolve the important and persistent conflict among the Courts of Appeals on this issue.

Wholly aside from its failure to apply the *National Muffler* factors once it reached step two of the *Chevron* analysis, the Sixth Circuit blatantly erred here in even going beyond *Chevron* step one. There is nothing

ambiguous about I.R.C. § 448(d)(5)(A)'s command that a taxpayer "shall not be required to accrue any portion" of accounts receivable that, based on experience, the taxpayer will not collect. That command quite plainly prohibits the Treasury from requiring taxpayers to accrue most of the accounts receivable that, based on their experience, they will not collect. This Court should clarify that *Chevron* does not absolve the courts of their responsibility "to say what the law is" when the meaning of the law is so clear. *Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 177 (1803).

I. THE SIXTH CIRCUIT'S REFUSAL TO APPLY THE *NATIONAL MUFFLER* FACTORS TO ASSESS THE REASONABLENESS OF INTERPRETIVE TREASURY REGULATIONS CONFLICTS SQUARELY WITH THE DECISIONS OF THIS COURT AND EIGHT OTHER COURTS OF APPEALS.

A. The *National Muffler* Factors Are A Fundamental Part Of The *Chevron* Analysis When A Court Reviews Interpretive Treasury Regulations.

In *Chevron*, this Court articulated the now familiar two-step analysis for the judicial evaluation of agency rulemaking. *Chevron*, 467 U.S. at 842-43. First, a court must consider "whether Congress has directly spoken to the precise question at issue." *Id.* at 842. If the intent of Congress is clear, the court's analysis is over. "[T]he court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* at 842-43. If the statute is silent or ambiguous with respect to the issue being considered, however, the court must consider whether the agency's regulation is based on a permissible construction of the statute. This second step of *Chevron* assumes different forms depending upon the

type of regulation involved. If Congress expressly delegated authority to an agency to promulgate a regulation, a court must give deference to that regulation unless it is "arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 843-44. If the delegation is implicit (as with interpretive regulations), a court is to defer to an agency's "reasonable interpretation." *Id.* at 844.

In reviewing most agency rulemakings, this Court's second-step *Chevron* analysis has focused on the traditional tools of statutory construction. In evaluating the reasonableness of an interpretive regulation, this Court has primarily examined the consistency of the regulation with the text and structure of the statute and its legislative history. *See, e.g., Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 485 (2001) (finding a regulation unreasonable that nullified the effect of certain statutes); *Lopez v. Davis*, 531 U.S. 230, 242-44 (2001) (upholding a regulation that was consistent with the statute's overall design); *Babbitt v. Sweet Home Chapter of Communities for a Great Or.*, 515 U.S. 687, 708 (1995) (finding a regulation to be a permissible construction after examining the legislative history of the statute).

In tax cases, this Court's *Chevron* step two analysis has involved a more searching review. In this area, the Court has made clear that, beyond analyzing whether the Treasury's "regulation harmonizes with the plain language of the statute, its origin, and its purpose," *Nat'l Muffler*, 440 U.S. at 477, a court must consider several additional factors:

> A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation

> dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.

Id.

Consideration of the factors articulated in *National Muffler* provides a comprehensive, searching review under *Chevron* step two. It encompasses not only whether a regulation can be reconciled with the text, structure, and history of the statute, but also the process by which the regulation was promulgated, whether the regulation is consistent with the Treasury's earlier interpretations of the statute, and how Congress responded to the regulation. The Sixth Circuit has acknowledged that consideration of the *National Muffler* factors provides a greater degree of scrutiny to administrative interpretations than typically occurs under *Chevron*. *See, e.g., Peoples Fed. Sav. & Loan Ass'n v. Comm'r*, 948 F.2d 289, 304 (6th Cir. 1991).

For three decades (both before and after the decision in *Chevron*), this Court has consistently applied the more rigorous analysis of the *National Muffler* factors to determine whether the Treasury's interpretation of an ambiguous statute merits controlling deference. *See, e.g., Boeing Co. v. United States*, 537 U.S. 437, 456-57 (2003) (examining congressional attention to the statute as indicative of its approval of the questioned regulation); *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 219 (2001) (noting that a regulation "may have particular

force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent" (quoting *Nat'l Muffler*, 440 U.S. at 477)); *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 31 (1982) (examining the manner in which the regulation evolved and was adopted); *see also* David A. Brennen, *Treasury Regulations and Judicial Deference in the Post-Chevron Era*, 13 Ga. St. U. L. Rev. 387, 426-29 (1997) (discussing the application of one of *National Muffler's* progeny as part of *Chevron* step two). This analysis was not affected by *United States v. Mead Corp.*, 533 U.S. 218 (2001), which clarified the circumstances in which *Chevron* deference applies. To the contrary, this Court applied the *National Muffler* factors last Term in *Boeing Co. v. United States*. *Boeing*, 537 U.S. at 455-57.

The overwhelming majority of the Courts of Appeals have adhered to this Court's teachings and faithfully employed the factors articulated in *National Muffler* and its progeny in assessing the reasonableness of the Treasury's interpretive regulations. *See, e.g., United States, IRS v. Craddock (In re Craddock)*, 149 F.3d 1249, 1258 (10th Cir. 1998); *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 981-83 (7th Cir.), *cert. denied*, 525 U.S. 961 (1998);[7]

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[7] Although the Seventh Circuit in *Bankers Life* purported to reject *National Muffler's* formulation of the reasonableness test—"whether [a] regulation harmonizes with the plain language of the statute, its origin, and its purpose"—it noted that *National Muffler* and *Chevron* are both based on one operative concept—reasonableness. And in assessing reasonableness in *Chevron* step two, the Seventh Circuit listed several of the *National Muffler* factors as informative including "the consistency of the agency's interpretation, the contemporaneousness of the interpretation, and the robustness of the regulation following congressional re-enactment of the underlying statute." *Bankers Life*, 142 F.3d at 983. Thus, while purporting to reject *National Muffler's* formulation of the appropriate deference standard, the Seventh Circuit—like the Third, Fourth, Fifth, Eighth, Ninth,

Snowa v. Comm'r, 123 F.3d 190, 197-200 (4th Cir. 1997); *Schuler Indus., Inc. v. United States*, 109 F.3d 753, 754-55 (Fed. Cir. 1997); *E.I. du Pont de Nemours & Co. v. Comm'r*, 41 F.3d 130, 136 (3d Cir. 1994); *St. Jude Med., Inc. v. Comm'r*, 34 F.3d 1394, 1400 (8th Cir. 1994); *Nalle v. Comm'r*, 997 F.2d 1134, 1136 (5th Cir. 1993); *Pac. First Fed. Sav. Bank v. Comm'r*, 961 F.2d 800, 803-04 (9th Cir.), *amended*, 92 D.A.R. 6873 (9th Cir. 1992), *and cert. denied*, 506 U.S. 872 (1992).

The Sixth Circuit, in contrast, has ignored this Court's teachings. It has squarely rejected use of the *National Muffler* factors as contrary to *Chevron*, and when applying *Chevron* has refused to consider how an interpretive Treasury regulation was issued, its consistency over time, or Congress's reaction to it in evaluating whether the regulation merits controlling deference. *See, e.g., Peoples Fed. Sav. & Loan Ass'n*, 948 F.2d at 304-05 (squarely rejecting consideration of the *National Muffler* factors, and noting that *Chevron* provides a greater degree of deference to administrative interpretations); *accord Ohio Periodical Distribs., Inc. v. Comm'r*, 105 F.3d 322, 324-26 (6th Cir. 1997) (employing *Chevron* without the *National Muffler* factors to assess Treasury regulations).

B. Consideration Of The *National Muffler* Factors Makes A Difference.

Because the *National Muffler* factors consider the care with which an interpretive Treasury regulation was promulgated, whether it was contemporaneous with the enactment of the statute, its longevity, its consistency, and whether it has impliedly been sanctioned by Congress, use of these factors provides a more searching review

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Tenth, and Federal Circuits – nonetheless used the *National Muffler* factors in its *Chevron* step two analysis.

than is afforded by the *Chevron* test as applied by the Sixth Circuit. As noted, the Sixth Circuit recognizes that use of the *National Muffler* factors affords less deference to the Treasury's interpretive regulations. *See, e.g., Peoples Fed. Sav. & Loan Ass'n*, 948 F.2d at 304. It could hardly be otherwise because the *National Muffler* factors require greater scrutiny than does the Sixth Circuit's version of *Chevron*.

That greater degree of scrutiny, unsurprisingly, has substantial effect. In numerous cases, the Circuits have upheld or invalidated interpretive Treasury regulations solely or largely on the basis of the *National Muffler* factors. *See, e.g., Nalle v. Comm'r*, 997 F.2d 1134, 1139 (5th Cir. 1993) (invalidating a regulation after noting that taxpayers had placed reliance upon the former interpretation and the Commissioner's inconsistent interpretations); *Hefti v. Comm'r*, 983 F.2d 868, 871-72 (8th Cir. 1993) (finding a regulation to be a reasonable interpretation after noting that it was a substantially contemporaneous construction, was consistently applied by the IRS, and had not been changed by a congressional amendment of the underlying statute), *cert. denied*, 508 U.S. 913 (1993); *Brown v. United States*, 890 F.2d 1329, 1338 (5th Cir. 1989) (upholding a regulation after noting that it represented a substantially contemporaneous construction and that Congress had approved the interpretation); *United States Trust Co. v. IRS*, 803 F.2d 1363, 1369-70 (5th Cir. 1986) (upholding the questioned regulation based upon an application of the *National Muffler* factors); *Water Quality Ass'n Employees' Benefit Corp. v. United States*, 795 F.2d 1303, 1309 (7th Cir. 1986) (invalidating a regulation after noting that it was not a "substantially contemporaneous construction" of the statute).

This case illustrates starkly the potential of the *National Muffler* factors to change the outcome of a taxpayer challenge. Indeed, this case *would* have been decided differently had it been heard in a different Circuit because each of the *National Muffler* factors weighs heavily against deferring to the interpretation underlying the Treasury's Revised Regulation:

First, the Revised Formula required by the Revised Regulation was not a "substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent." *Nat'l Muffler*, 440 U.S. at 477. In fact, the Treasury initially adopted the formula that Petitioners used when I.R.C. § 448(d)(5) was first enacted.

Second, because the Treasury mandated use of the Revised Formula to estimate uncollectible accounts receivable only ten months after requiring the use of a very different formula, the lack of "consistency of the Commissioner's interpretation" counsels against substantial deference. *Id.*

Third, "the manner in which [the Revised Regulation] evolved," *id.*, demonstrates an absence of the thorough agency consideration to which a court may defer. Although the Treasury (like other agencies) is permitted to issue temporary regulations without notice and public comment "for good cause" where those procedures are "impracticable, unnecessary, or contrary to the public interest," 5 U.S.C. § 553(b)(B), the Treasury cited no good cause (or, indeed, any cause) for avoiding those procedures here. The Treasury had cited a need promptly to issue regulations interpreting the Tax Reform Act of 1986 as the reason for issuing the Original Regulation in the form of a temporary regulation. But there was no similar need for haste in promulgating the

Revised Regulation. Its hurried release on April 14, 1988 strongly suggests that the Treasury may have rushed to adopt the Revised Regulation before the November 20, 1988 effective date of I.R.C. § 7805(e), which requires all temporary regulations issued thereafter to expire within three years of issuance. The Revised Regulation remained in effect thereafter as a "temporary" regulation for more than a decade, without undergoing the rigors of true notice and comment. Where, as here, agency interpretations were issued without being subjected to notice and comment rulemaking, such interpretations generally "do not warrant *Chevron*-style deference." *Christensen v. Harris County*, 529 U.S. 576, 587 (2000).

Finally, in this instance, the "scrutiny Congress ... devoted to the regulation during subsequent re-enactments of the statute" counsels strongly against deference. *Nat'l Muffler*, 440 U.S. at 477. Not only did Congress not validate the Revised Regulation by reenacting I.R.C. § 448(d)(5) without change, but, to the contrary, the first (and only) time that Congress addressed section 448(d)(5), it repudiated the Revised Regulation as directly contrary to the statute's purpose. Congress amended section 448(d)(5) explicitly to clarify that the Service may not require the use of the Revised Formula and took the extraordinary step of directing the Treasury to issue corrected regulations. *See* I.R.C. § 448(d)(5)(C) (directing the Treasury to issue corrected regulations that would permit a taxpayer to calculate bad debt expense "using computations or formulas which, based on experience, accurately reflect the amount of income that will not be collected by such person").

C. The Conflict Among The Courts Of Appeals Over The Use Of The *National Muffler* Factors Warrants This Court's Plenary Review.

The Sixth Circuit has acknowledged its conflict with the other Circuits regarding use of the *National Muffler* factors and consciously decided to go its own way. *See Peoples Fed. Sav. & Loan Ass'n*, 948 F.2d at 304. As demonstrated, this choice to ignore the *National Muffler* factors affected the outcome of this case and will continue in the future to prevent taxpayers from receiving equal justice in the Courts of Appeals. Absent this Court's review, the levels of scrutiny to which the Treasury's interpretive regulations will be subject will differ dramatically, which in turn will often lead to different results depending on the Circuit in which a taxpayer brings its case.

Numerous courts and commentators have bemoaned the uncertainty and confusion created by this split among the circuits. *See, e.g., Gen. Elec. Co. v. Comm'r*, 245 F.3d 149, 154 n.8 (2d Cir. 2001) (noting the amount of deference to be applied to a Treasury regulation is unsettled); Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 Fla. Tax Rev. 51, 70 (1996); *Report of the Task Force on Judicial Deference*, ABA Section of Taxation, to be published in the Spring 2004 issue of *The Tax Lawyer*, *available at* http://www.abanet.org/tax/pubs/ttl/572sp04/juddef.pdf (last visited May 10, 2004). "Uniformity among the circuits is especially important in tax cases to ensure equal and certain administration of the tax system." *First Charter Fin. Corp. v. United States*, 669 F.2d 1342, 1345 (9th Cir. 1982) (citing *Gulf Inland Corp. v. United States*, 570 F.2d 1277, 1278 (5th Cir. 1978); *N. Am. Life & Cas. Co. v. Comm'r*, 533 F.2d 1046, 1051 (8th Cir. 1976); *Fed. Life Ins. Co. v. United States*, 527 F.2d 1096,

1098-99 (7th Cir. 1975)). Such uniformity can be restored here only by a decision of this Court.

II. THE SIXTH CIRCUIT SHOULD HAVE STOPPED AT *CHEVRON* STEP ONE IN THIS CASE BECAUSE THE MEANING OF I.R.C. § 448(d)(5) WAS CRYSTAL CLEAR.

A. The Treasury's Requirement That All Taxpayers Use The Revised Formula, Regardless Of Whether It Accurately Reflected Their Bad Debt Experience, Conflicted With The Plain Text Of I.R.C. § 448(d)(5).

A court's review must end with *Chevron's* first step if, employing traditional tools of statutory analysis, the court finds the intent of Congress clear on the question at issue. *See, e.g., Gen. Dynamics Land Sys., Inc. v. Cline*, 124 S. Ct. 1236, 1248 (2004); *see also Chevron*, 467 U.S. at 842-43 ("[T]he court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."). Under that established rule, the Sixth Circuit should never have gone beyond *Chevron* step one, as Congress's intent in I.R.C. § 448(d)(5) could hardly have been clearer.

When the Revised Regulation was promulgated, section 448(d)(5)(A) stated: "In the case of any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person, such person shall not be required to accrue any portion of such amounts which (on the basis of experience) will not be collected." I.R.C. § 448(d)(5)(A). The Sixth Circuit recognized that this meant that "service providers ... need not accrue any part of receivables that *their* experience indicates they will not collect." Pet. App. 4a (emphasis added). The government acknowledged the same. *See* Final Brief for the Appellee ("Gov't Brief") at 21, 30, *Hospital Corp. of Am. v. Comm'r*, 348 F.3d 136 (6th

Cir. 2003) (No. 01-1810). The trial record established, and neither the government nor the Sixth Circuit disputed, that use of the Revised Formula forced Petitioners to accrue as income more than 80% of the receivables that their experience indicated they would never collect. The Revised Formula thus compelled a result that was jarringly inconsistent with what the Sixth Circuit and the government acknowledged the statute required. Recognition of this fact should have concluded the Sixth Circuit's *Chevron* analysis.

Instead, the Sixth Circuit declared that Congress's intent under section 448(d)(5) was "ambiguous with respect to the intended formula." Pet. App. 13a. This was a non sequitur. I.R.C. § 448(d)(5) did not specify the use of a particular "intended formula" or any formula at all. The statute, therefore, might have permitted the Treasury to allow a variety of different formulas, or (as it did under *Black Motor*) to allow taxpayers to demonstrate in other ways the amounts that should be excluded from income. But the statute made crystal clear that any formula (or other approach) prescribed by the Treasury "shall not" require the taxpayer to accrue any portion of the amount that its experience indicated it would not collect. That prohibition was unambiguous, and the Revised Regulation unequivocally violated it. Thus, the Sixth Circuit should not have proceeded to a *Chevron* step two analysis.

B. The Sixth Circuit's Reliance On I.R.C. § 448(d)(5)'s Ambiguous Legislative History To Justify Ignoring The Statute's Plain Text Turns The Normal Canons Of Statutory Construction On Their Heads.

The Sixth Circuit apparently affirmed the mandatory use of the Revised Formula based on the statute's

legislative history, despite the Revised Formula's acknowledged failure to reflect Petitioners' experience as required by the text of section 448(d)(5). Pet. App. 14a. This, of course, turned the normal canons of construction on their heads. Ordinarily, it is permissible to consider legislative history only when a statute's text is ambiguous, *United States v. Pub. Utils. Comm'n of Cal.*, 345 U.S. 295, 315 (1953), and legislative history is never rightly used to alter the meaning of unambiguous text. *See, e.g., Bedroc Ltd. v. United States*, 124 S. Ct. 1587, 1595 (2004). Those principles should apply all the more rigorously where, as here, it is the legislative history that is ambiguous and not the statute.

The legislative history for which the Sixth Circuit forsook the clear command of I.R.C. § 448(d)(5) is House Report No. 99-426, which attempts to discuss a single formula (seemingly, the Original Formula) but then sets out two different ones.[8] Thus, the House Report describes a formula that bases its calculation upon the *total amount billed* during a year, but, in the example it provides to illustrate that formula, sets forth a contrary calculation based upon the *total receivables outstanding* at the end of the taxable year.[9] In other words, the

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[8] H.R. Rep. No. 99-426 (1985), *reprinted in* 1986-3 C.B. Vol. 2.

[9] The relevant passage of the House Report reads as follows:

> The amount of billings that, on the basis of experience, will not be collected is equal to *the total amount billed*, multiplied by a fraction whose numerator is the total amount of such receivables which were billed and determined not to be collectible within the most recent five years [sic] taxable years of the taxpayer, and whose denominator is the total of such amounts billed within the same five year period.

illustrative example changes the amount to which the ratio was to be applied from total billings to total receivables outstanding at year-end – the method used in the *Black Motor* formula.

The House Report's drafters plainly did not intend for their example to conflict with the formula it was supposed to illustrate. Other legislative history suggests that the drafters likely believed that they were describing the *Black Motor* formula and intended their textual example to illustrate the same.[10]

H.R. Rep. No. 99-426, *reprinted in* 1986-3 C.B. Vol. 2, at 608 (emphasis added). In the very next paragraph, an example is given that conflicts with the preceding narrative language it purports to illustrate:

> For example, assume that an accrual-basis taxpayer has $100,000 of receivables that have been created during the most recent five taxable years. Of the $100,000 of accounts receivable, $1,000 have been determined to be uncollectible. The amount, based on experience, which is not expected to be collected is equal to 1 percent ($1,000 divided by $100,000) of *any receivable* arising from the provision of services that are [sic] *outstanding at close of the taxable year.*

Id. (emphasis added).

[10] In describing the bad debt reserve method being repealed by the 1986 Act, the House Report explains:

> The most widely used formula for determining the appropriate bad debt reserve for tax purposes is based on the decision in *Black Motor Company v. Commissioner*, 41 B.T.A. 300 (1940), affd 125 F. 2d 977 (6th Cir. 1941). This formula uses a six year moving average, determined by dividing the sum of bad debts actually charged off (net of actual recoveries) for the most recent six years (including the current year) by the *sum of the debts owed the taxpayer over the same six year period.* This average is multiplied by the amount of *debts outstanding at the close of the current*

Indeed, the Treasury initially read the legislative history as describing the *Black Motor* formula. In the preamble to the Original Regulation, the Treasury stated that it was adopting the Original Formula (which tracked *Black Motor*) "based on" the legislative history previously described.[11] The Original Regulation, as a contemporaneous interpretation of the statute, gives the best evidence of Congress's intent and thus of how to read the legislative history. *See generally Bingler v. Johnson*, 394 U.S. 741, 749-50 (1969). When the Treasury later decided to change the formula, it changed its interpretation of the legislative history as well, and without explanation cited the very same passages to support the Revised Formula.

In any event, whatever formula or formulas the drafters of the House Report might have intended to reference—which is unknowable, given the Report's confused text—this legislative history nowhere suggests that the Treasury was permitted to require a taxpayer to use a formula that failed to reflect the taxpayer's experience, in direct violation of the statutory text. In parsing the confused legislative history for hidden meaning and ignoring the statutory text, the Sixth Circuit missed the point of the statute entirely.

> *year* to produce the reserve balance at the close of the current year.

H.R. Rep. No. 99-426, *reprinted in* 1986-3 C.B. Vol. 2, at 639 (emphasis added). This language purporting to describe the *Black Motor* formula multiplies year-end receivables by a ratio of net bad debts to total receivables. The *Black Motor* formula, however, used a ratio of net bad debts to year-end receivables—not to total receivables. The same mistake was made in the example on page 608 of the House Report described above.

[11] T.D. 8143, 52 Fed. Reg. 22,764 (June 16, 1987).

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS
SIXTH CIRCUIT

HOSPITAL CORPORATION OF AMERICA & SUBSIDIARIES,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 01-1810

Argued: Mar. 11, 2003.
Decided and Filed: Oct. 30, 2003.

Before: MARTIN and ROGERS, Circuit Judges; EDMUNDS, District Judge.*

OPINION

BOYCE F. MARTIN, JR., Circuit Judge.

The petitioner, Hospital Corporation of America and subsidiaries, appeals from two decisions of the United States Tax Court ruling in favor of the Commissioner of the Internal Revenue. First, the Tax Court found that the Secretary of the Treasury reasonably interpreted Internal Revenue Code Section 448(d)(5) in promulgating a mandatory formula to calculate expected uncollectible receivables. Second, the Tax Court ruled that Hospital Corporation must report in a single taxable year the

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* The Honorable Nancy G. Edmunds, United States District Judge for the Eastern District of Michigan, sitting by designation.

entire remaining balance of an adjustment resulting from a change in accounting methods, an adjustment that Hospital Corporation argued could be spread out over ten years. For the following reasons, we AFFIRM the Tax Court on both issues.

I. BACKGROUND

Factual Background

In 1987, some Hospital Corporation subsidiaries changed to the accrual accounting method and took into account positive adjustments under Section 481(a) on their 1987 tax returns. The Hospital Corporation companies not operating hospitals spread the adjustment over four years; those operating hospitals spread the adjustment over ten years.

On September 1, 1987, HCA Investments, Inc., a wholly-owned subsidiary of Hospital Corporation, sold all of the stock of subsidiaries that owned and operated hospitals, office buildings, and related medical facilities to HealthTrust, Inc.-The Hospital Company. HealthTrust did not want all of the subsidiary's assets, so the subsidiary transferred the assets that HealthTrust wanted to a new subsidiary. This made the subsidiary losing the assets a parent of the newly-formed subsidiary. The new parent then transferred the stock of the new subsidiary to HCA Investments in exchange for HCA Investments stock. HCA Investments then sold the new subsidiary, which contained the assets HealthTrust wanted, to HealthTrust. The new subsidiaries were separate enterprises with separate books and records.

From 1987 through 1996, the new parent companies that had relinquished facilities to new subsidiaries proportionally reported the balance of adjustments. The adjustments included those attributable to the facilities that were transferred to the new subsidiaries.

The Internal Revenue Service determined that the Hospital Corporation subsidiaries that became new parents to the new subsidiaries incorrectly reported income. The Service concluded that these Hospital Corporation subsidiaries must include the entire balance of the adjustment in 1987 income, rather than report it proportionally over ten years, with respect to those hospitals they had ceased to operate.

The parties dispute two issues regarding the treatment of bad accounts and the inclusion of adjustments following the change in accounting method. The first issue is how Hospital Corporation may calculate the amount to exclude from income because a portion of accounts receivable will not be collected. If the Commissioner prevails, Hospital Corporation must use the most recent formula given in Temporary Treasury Regulation Section 1-448-2T (as amended in 1987), the temporary amended regulation interpreting Section 448(d)(5). T.D. 8194, 1988-1 C.B. 186, 187. If Hospital Corporation prevails, it may use an older formula in which the ratio is obtained by dividing the same six-year average of bad accounts by the sum of year-end accounts receivable, or accounts still owing, for each year of the period. Temp. Treas. Reg. § 1-4482T(e)(2)(I), T.D. 8143, 1987-2 C.B. 121.

The second issue is whether the Hospital Corporation subsidiaries that still operated some hospitals could still get the statutory benefit available to "a hospital" with respect to hospitals they had spun off. If the answer is yes, the Hospital Corporation subsidiaries as new parents may report the adjustment over a ten-year spread. If the answer is no, the Hospital Corporation subsidiaries that became new parents must include in 1987 income *all* of the adjustment balance with respect to hospitals they ceased to operate.

Statutory Background

In 1986, Congress passed the Tax Reform Act. *See* Pub.L. 99-514, 100 Stat. 2345. A provision of the Act repealed Section 166 of the Internal Revenue Code, which had allowed corporate taxpayers to determine the amount of bad debt deductions, or accounts that would not be paid by those who owed the corporation, by using an accounting method called the reserve method. The Act added Section 448 to the Code, which required use of the accrual method of accounting for receivables. *See* 26 U.S.C. § 448.

Section 448(d)(5) states that service providers, such as hospitals who must use the accrual method, need not accrue any part of receivables that their experience indicates they will not collect. This is termed the "nonaccrual experience method." In significant part, Section 448(d)(5) provides[1]:

> (5) Special rule for services.—In the case of any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person, such person shall not be required to accrue any portion of such amounts which (on the basis of experience) will not be collected.

In June 1987, the Treasury Department issued proposed Temporary Treasury Regulation Section 1.448-2T, which provided a mandatory formula to compute the amounts of receivables that are unlikely to be collected and,

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[1] The statute has since been revised to give the Secretary express authority to prescribe a regulation that provides a method to determine the nonaccrual amounts but also allows the taxpayer to request a change from the prescribed formula. *See* 26 U.S.C. § 448(d)(5)(C).

accordingly, need not be accrued. *See* 52 Fed.Reg. 22764 and 22795 (1987).

Changing the accounting method to an accrual method can cause amounts in the books to be omitted or duplicated. An adjustment is sometimes necessary to prevent such an omission or duplication. A positive adjustment increases taxable income, just as a negative adjustment decreases taxable income. Internal Revenue Code Section 481 describes when a taxpayer should incorporate an adjustment brought about by changing its accounting method. Section 481(a) requires that taxpayers take into account for the year of change the adjustments that are necessary because of the change.

For certain taxpayers, Section 448(d)(7) of the Code allows an extended period for taking into account adjustments. For most taxpayers affected, the spread period is no more than four years, but for hospitals it is ten years. Section 448(d)(7) provides:

> (7) Coordination with section 481.--In the case of any taxpayer required by this section to change its method of accounting for any taxable year–
>
> (A) such change shall be treated as initiated by the taxpayer,
>
> (B) such change shall be treated as made with the consent of the Secretary, and
>
> (C) the period for taking into account the adjustments under section 481 by reason of such change–
>
> (i) except as provided in clause (ii), shall not exceed 4 years, and
>
> (ii) in the case of a hospital, shall be 10 years.

The Treasury Department further interpreted Section 448 in Tax Regulation Section 1.448-1(g)(3)(iii) to cover situations where the taxpayer ceases to engage in the trade in which it had been operating. If the cessation of trade happens before the four- or ten-year adjustment period ends, the taxpayer must take into account the entire remaining balance of the adjustment in the taxable year in which it stopped the business.

II. ANALYSIS

Standards of Review

We review decisions of the Tax Court as we would review a district court decision in civil actions tried without a jury; thus, where the Tax Court interpreted statutory provisions and agency regulations, we review its decisions *de novo*. *See Wolpaw v. Comm'r of Internal Revenue*, 47 F.3d 787, 790 (6th Cir.1995).

We agree with the Tax Court that the agency regulations at issue in this case should be evaluated under the principles of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984), which held that:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would

> be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

467 U.S. at 842-43, 104 S.Ct. 2778 (footnotes omitted). This court has applied the *Chevron* analysis to interpretive Treasury Regulations. *Ohio Periodical Distribs., Inc. v. Comm'r*, 105 F.3d 322, 324-26 (6th Cir.1997). And indeed, *Chevron* itself involved deference to an agency interpretation of a statutory term. In *Chevron* the Environmental Protection Agency promulgated a regulation providing for the meaning of the statutory term "stationary source." 467 U.S. at 840, n. 2, 104 S.Ct. 2778. The Court took the ambiguity of the statutory term to be an implicit delegation to the agency to give meaning to the term, *see* 467 U.S. at 844, 104 S.Ct. 2778, and the Court was accordingly required to accept the Agency's definition once the Court found that it was a permissible one.

At issue in this case is the weight attached to the regulations, which were not issued under an express statutory provision to set forth rules implementing the particular sections of the Code. *See* I.R.C. Ch. 1, Subchapter E. § 441 *et. seq.* The regulations were issued under the Secretary of the Treasury's rulemaking authority pursuant to Internal Revenue Code Section 7805(a), which gives the Secretary general authority to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code. Such regulations are appropriately accorded *Chevron* deference when they constitute an exercise of implicitly delegated power to give content to ambiguous statutory terms. As

the Supreme Court held in *Boeing Company v. United States*, "if we regard the challenged regulation as interpretive because it was promulgated under § 7805(a)'s general rulemaking grant rather than pursuant to a specific grant of authority, we must still treat the regulation with deference." 537 U.S. 437, 123 S.Ct. 1099, 1107, 155 L.Ed.2d 17 (2003) (citing *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 560-61, 111 S.Ct. 1503, 113 L.Ed.2d 589 (1991)).

Recently, the Supreme Court recognized in *United States v. Mead Corporation*, 533 U.S. 218, 121 S.Ct. 2164, 150 L.Ed.2d 292 (2001), that when Congress does not expressly delegate authority to an agency, an agency interpretation may still qualify for *Chevron* deference if Congress delegated authority to the agency generally to make rules carrying the force of law, as shown in ways like agency power to engage in notice-and-comment rulemaking. *See id.* at 229, 121 S.Ct. 2164.[2]

This Court has addressed the deference due a regulation made under an implicit delegation of authority to an agency, concluding that without an express delegation of authority, the authority is implicit, yet the court must uphold the administrative interpretation of a statutory provision if it is reasonable. *See Nichols v. United States*, 260 F.3d 637, 644 (6th Cir.2001). When the Treasury's authority is implicit, we have directed, "*a court may not substitute its own construction* for the reasonable interpretation of an agency." *Peoples Fed. Sav. and Loan Ass'n of Sidney v. Comm'r*, 948 F.2d 289, 300 (6th Cir.1991) (internal citations omitted).

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[2] As explained later in this opinion, to the extent that the Supreme Court limited the applicability of *Chevron* deference in *Mead Corporation*, *Mead Corporation* is distinguishable from the present case.

The Court recently expressed its approach to deciding the validity of tax regulations in *United States v. Cleveland Indians Baseball Company*, 532 U.S. 200, 218-19, 121 S.Ct. 1433, 149 L.Ed.2d 401 (2001):

> "[W]e do not sit as a committee of revision to perfect the administration of the tax laws." *United States v. Correll*, 389 U.S. 299, 306-307, 88 S.Ct. 445, 19 L.Ed.2d 537 (1967). Instead, we defer to the Commissioner's regulations as long as they "implement the congressional mandate in some reasonable manner." *Id.* at 307, 88 S.Ct. 445. "We do this because Congress has delegated to the [Commissioner], not to the courts, the task of prescribing all needful rules and regulations for the enforcement of the Internal Revenue Code." *Nat'l Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 477, 99 S.Ct. 1304, 59 L.Ed.2d 519 (1979) (citing *Correll*, 389 U.S. at 307, 88 S.Ct. 445 (citing 26 U.S.C. § 7805(a))).

Thus, though we review the Tax Court's findings of law *de novo* and must ensure the Treasury has made at least a reasonable choice among permissible interpretations of its statute, we must not impose our own choices.

Non-Accrual Formula Issue

The Tax Reform Act of 1986 repealed the reserve method as improperly allowing a deduction for a loss that was to occur in the future. *See* H.R.Rep. No. 99-426, 99th Cong., 1st Sess. 577 (1985). The Act also required many taxpayers to use the accrual method of accounting but made a provision for some taxpayers to account for bad debts attributable to services rendered. In 1987, Section 448(d)(5) of the Internal Revenue Code took effect, whereby taxpayers did not have to accrue income

for services rendered that experience showed would not be collected. Only taxpayers that provide services and do not charge interest or penalties for late payment may avoid accrual of uncollectible accounts under Section 448(d)(5).

Section 448(d)(5) does not mandate any formula or provide guidance on computing the exclusion from income, only stating that the computation be made "on the basis of [the] experience" of a taxpayer. Legislative history provided two formulas, an inconsistency the Tax Court recognized. In the House Report, Congress first described a formula in which "total amount billed" would be multiplied by the ratio of amount uncollectible in the last five years divided by total amount billed in the last five years. The formula appears as:

Estimated year-end uncollectible receivables =
Total billed X Total uncollectible last five years
Total billed last five years

The next paragraph of the House Report, however, purported to provide an example. In the example, the difference was that the ratio was applied to the receivables existing at the end of the taxable year. This formula appears as:

Estimated year-end uncollectible receivables =
Receivables outstanding at year end X
Total uncollectible last five years
Total billed last five years

The Secretary issued a Temporary Treasury Regulation interpreting Section 448 and requiring accrual-method taxpayers who employ the non-accrual experience method for bad accounts to use a third formula, the *Black Motor* formula, to estimate the uncollectible amount, approved by the Tax Court in *Black Motor Company v. Commissioner*, 41 B.T.A. 300 (1940), *aff'd on other grounds*, 125 F.2d 977 (6th Cir.1942). In this

formula, a taxpayer estimated the portion of year-end receivables that would not be collected by multiplying the year-end receivables outstanding by the ratio of average bad debt write- offs for the current year and the immediately preceding five years, divided by the average year-end receivables for the same period. The formula looked like this:

Estimated year-end uncollectible receivables =
Receivables outstanding at end of year X
Average of bad debt write offs for last six years
Average ***year-end receivables*** *for last six years*

The Supreme Court approved the *Black Motor* formula in *Thor Power Tool Company v. Commissioner*, 439 U.S. 522, 549, 99 S.Ct. 773, 58 L.Ed.2d 785 (1979). The Court commented that while not without its faults—such as not giving a taxpayer's recent experience more weight than experience from a few years ago—the *Black Motor* formula had the advantage of "enhancing certainty and predictability in an area peculiarly susceptible of taxpayer abuse." *Id.* The Court, however, noted that the Commissioner had issued a formal ruling adopting *Black Motor* but also allowed a taxpayer to avoid the *Black Motor* formula if it met its burden to show that the formula would produce an unreasonable result. *See id.* If a taxpayer showed that an amount greater than the estimated amount produced using the *Black Motor* formula was reasonable, it could use the greater amount to determine the addition to its reserve for bad debts. *See id.*

In the preamble to the Treasury Decision issuing the Temporary Regulation, the Secretary pointed out that the House Report contained a reference to a formula, and then stated that the regulations were adopting a six-year moving average formula. *See* T.D. 8143, 1987 C.B. Soon

after the regulation was issued, the Secretary became aware that some taxpayers were excluding large amounts of accounts receivable, usually in businesses where the companies could write off bad debt receivables in less than a year, as in the case of utility companies. The Treasury issued a revised Temporary Regulation, which required a new mandatory formula. *See* 53 Fed.Reg. 12513 (1988). The Secretary noted that taxpayers expressed confusion in determining whether the denominator should include total sales or year-end balances of accounts receivable. *See* T.D. 8194, 1988-1 C.B. at 186. The revised formula computes the estimated uncollectible receivables by multiplying the year-end receivables for the current year by a ratio of average bad debts written off during the current year and the previous five years, divided by its average total sales for the same period. *See* Treas. Reg. § 1.448-2T(e)(2). The formula looks like this:

Estimated uncollectible receivables =
Receivables outstanding year-end X
Average bad debts written off for six years
Average ***total annual charges for six*** *years*

The difference between the *Black Motor* formula and the revised formula is the denominator in the ratio. In the former, the denominator is the average year-end receivables—in other words, the accounts remaining to be paid. In the latter, the denominator is the total receivables arising in a year, including accounts that have been paid plus accounts with an outstanding balance. The revised formula is the same as in the House Report, though it uses current-year data in addition to five-year history.

Hospital Corporation argues that it should be allowed to use the *Black Motor* formula because it more accurately

reflects its bad debt experience. Hospital Corporation used the *Black Motor* formula to determine the portion of year-end receivables it would not collect and would not be required to accrue for the 1987 and 1988 tax years. Using the *Black Motor* formula, Hospital Corporation would exclude 19.9 percent of outstanding receivables at the end of 1987 and 20.6 percent of receivables outstanding at the end of 1988, figures it argues are consistent with previous years. Use of the revised formula, claims Hospital Corporation, would result in the exclusion of only about four percent of year-end receivables.

Hospital Corporation adopted the nonaccrual experience method of accounting and then indicated it would use a periodic system in computing the exclusion pursuant to Internal Revenue Service Notice 88-51. Hospital Corporation did not, however, follow Notice 88-51, which also mandates the revised formula, and instead computed the excludable income using the *Black Motor* formula.

When analyzing agency action, we start with the language of the statute. *See United States v. Am. Trucking Ass'n, Inc.*, 310 U.S. 534, 543, 60 S.Ct. 1059, 84 L.Ed. 1345 (1940). The Tax Court concluded, in this case, that Section 448(d)(5) was ambiguous. It observed that the statute provided no formula and merely used the words "basis of experience" without delineating what experience was intended. The Tax Court noted other statutes in which Congress adopted a specific formula, giving it support for the determination that Section 448(d)(5) is ambiguous with respect to the intended formula. We agree. Moreover, nothing in the statute or its legislative history indicates that Congress intended to allow an alternative formula, though the House Report seemingly describes two different formulas.

Under *Chevron*, once we determine that the statute is ambiguous, we must decide whether the Treasury regulation is a reasonable interpretation of the statute. We hold that it is. A Treasury regulation must be upheld if it "'implement[s] the congressional mandate in some reasonable manner.'" *Rowan Cos. v. United States*, 452 U.S. 247, 252, 101 S.Ct. 2288, 68 L.Ed.2d 814 (1981) (quoting *United States v. Correll*, 389 U.S. 299, 307, 88 S.Ct. 445, 19 L.Ed.2d 537 (1967)). The statute provides that a taxpayer shall not be required to accrue amounts that, based on the taxpayer's experience, will not be collected. Hospital Corporation argues that the revised formula issued in the Treasury regulation is flawed mathematically, producing a result that is not based on its experience. Rather, the final number will be artificially low, forcing it to accrue amounts that it will not collect. Hospital Corporation argues that uncollectible amounts should be computed with a different formula if the amounts from the mandatory formula do not accurately reflect experience.

We must follow our own precedent and that of the Supreme Court and not substitute our own construction of the tax law where the regulation at issue is reasonable. *See Chevron*, 467 U.S. at 843, 104 S.Ct. 2778. Several permissible constructions may be reasonable, and where Congress has left gaps, agencies may fill the gaps with necessary rules that are reasonable. *See id.* The Court directs that we "should not interfere with this process," *id.*, which is what would happen were we to decide whether a method is the better of two possibilities. We need only determine if the one chosen by the Treasury is reasonable. In reviewing the legislative history of the statute and the Treasury Decisions promulgating the regulation, we conclude that the Treasury did not act arbitrarily but selected a reasonable method to measure accounts that should not be accrued from experience.

Hospital Corporation also argues that the revised temporary regulation should be invalid even if we were to find it consistent with the statute. First, Hospital Corporation reasons that the Tax Court believed the revised regulation must receive *Chevron* deference, but relying upon *Mead Corporation, supra,* Hospital Corporation believes the Tax Court erred and should have accorded no deference. According to Hospital Corporation, the revised regulation was not issued pursuant to an express or implicit delegation of legislative rulemaking power. Nothing in Section 448(d)(5) authorized legislative rulemaking, but instead, the Treasury's general interpretive authority in the Internal Revenue Code gave it authority to issue the regulation, thus making the revised regulation an interpretive regulation. *See* I.R.C. § 7805(a). The Treasury recognized that it was issuing a regulation that need not comply with the Administrative Procedure Act and Regulatory Flexibility Act when it published the revised regulation. *See* 53 Fed.Reg. 124534.

The fact that the temporary regulation was not subject to notice and comment does not, moreover, require us to eschew *Chevron* deference, notwithstanding the Supreme Court's recent decision in *Mead Corporation.* In *Mead Corporation,* the Court found that Congress had not implicitly delegated law-interpreting authority through the 10,000 to 15,000 tariff rulings made each year by forty-six different Customs offices without notice and comment procedures. *See* 533 U.S. at 232-33, 121 S.Ct. 2164. The Court made clear, however, that while most of the Supreme Court cases applying *Chevron* involved notice-and-comment rulemaking or formal adjudication, "the want of such procedure ... does not decide the case, for we have sometimes found reasons for *Chevron* deference even when no such administrative formality was required

and none was afforded." 533 U.S. at 231, 121 S.Ct. 2164. The temporary regulations involved in this case were arrived at centrally by the Treasury Department, after careful consideration. They were issued pursuant to statutory authority to "prescribe" needful rules and regulations. *See* I.R.C. § 7805(a). The regulation was "interpretive" in the same sense that the regulation in *Chevron* was interpretive—it gave content to ambiguous statutory terms. Congress clearly intended that the Treasury Department do so, and *Chevron* deference is therefore appropriate.[3]

Based upon the above reasons, we hold that the Temporary Treasury Regulation at issue is a reasonable interpretation of the Internal Revenue Code provision and is entitled to deference. The Secretary did not act in an unreasonable or arbitrary manner by employing a formula from the legislative history that he thought would effectuate the statutory mandate.

Timing of the Section 481 Adjustment

As discussed *supra*, Section 448(d)(7) of the Internal Revenue Code governs the Section 481 adjustment that taxpayers make where they have been required to change accounting method. Section 448(d)(7) states that the change will be treated as initiated by the taxpayer with the consent of the Secretary and that the period for taking into account the adjustment shall not exceed four years, except that for hospitals the period "shall be 10 years." *Id.* Treasury Regulation Section 1.448-1(g)(2)(ii) provides

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[3] Hospital Corporation does not challenge the temporary regulations as violations of the notice and comment requirements for rulemaking, *see* 5 U.S.C. § 553. Accordingly, we do not reach the issue of whether the Administrative Procedure Act requires notice and comment procedures before Treasury may promulgate temporary interpretive regulations that make substantive choices among permissible statutory interpretations.

in pertinent part that "[i]n the case of a hospital that is required by this section to change from the cash method, the section 481(a) adjustment shall be taken into account ratably (beginning with the year of change) over 10 years." The regulation further specifies what is to occur when a taxpayer ceases the trade or business to which the adjustment related. Treasury Regulation Section 1.448-1(g)(3)(iii) states:

> If a taxpayer ceases to engage in the trade or business to which the section 481(a) adjustment relates ... and such cessation or termination occurs prior to the expiration of the adjustment period described in paragraph (g)(2)(i) or (ii) of the section, the taxpayer must take into account, in the taxable year of such cessation or termination, the balance of the adjustment not previously taken into account in computing taxable income ....

In 1987, Hospital Corporation sold over one hundred of its hospitals. At issue is the applicability of the cessation of trade section for those hospitals transferred to new subsidiaries from new parents. Hospital Corporation argues that the subsidiaries' operation of hospitals not sold to HealthTrust allows it to spread the adjustments attributable to those hospitals over ten years. Hospital Corporation's contention is that the cessation of business provision is contrary to the portion of the Internal Revenue Code requiring a hospital to take a ten-year spread. The Commissioner and Tax Court, however, reject this view of the regulation.

The Tax Court upheld the regulation, determining that the statute was ambiguous and that the regulation was a reasonable interpretation. The statute here does not specifically address the possibility that a taxpayer

may cease operating the business that gave rise to the adjustment, without regard to the nature of the business. Hospital Corporation argues that the statute clearly and unambiguously states that the adjustment period for hospitals "shall be 10 years," so the cessation of business provision conflicts by not allowing the entire ten-year spread that the statute mandates. The statute states that the adjustment period for non-hospitals, in contrast, cannot "exceed four years." Thus, Hospital Corporation argues that unlike the hospital taxpayer, the non-hospital taxpayer is not mandated to a set number of years.

The legislative history does not explain why hospitals were to be treated differently, nor does it address the situation in which a business owns several hospitals rather than a sole facility. The first version of the Code provision, as reported by the House Committee on Ways and Means, mandated that the period "shall not exceed 5 years (10 years in the case of a hospital ...)." H.R. 3838, 99th Congress 1985. Hospital Corporation points out that Congress ultimately revised the "shall not exceed" phrase for a hospital and instead enacted "shall be 10 years for a hospital." The Committee Report to the final bill provided that a Section 481(a) adjustment "generally shall be taken into account over a period not to exceed four years," but "[i]n the case of a hospital, the adjustment shall be taken into account ratably over a ten-year period." H.R.Rep. No. 99-841.

Section 5.09 of Revenue Procedure 84-74 states that where a taxpayer ceases to engage in the trade or business to which the adjustment relates, it shall take into account the balance of the adjustment in that taxable year. The procedure refers to an earlier Revenue Ruling, which holds that if a division of the corporate taxpayer ceases to operate a trade or business, the taxpayer must take the adjustment into account in the year of cessation. *See* Rev.

Proc. 84-74 (citing Rev. Rul. 80-39, 1980-1 C.B. 112). Revenue Ruling 80-39 reasons that allowing a corporation to spread the adjustment over years subsequent to the time its division ceased the trade or business would distort the corporation's income during that spread period. Neither the Revenue Procedure nor the Revenue Ruling singles out hospitals for different treatment, nor even mentions the word hospital.

The Tax Court found ambiguity because the statute states "in the case of a hospital" in the singular and does not address the case of a business owning several hospitals. This was relevant to the Tax Court because the Code does not decide the question whether the ten-year spread of the adjustment belongs to each individual hospital or to the business that owned the hospitals. The Tax Court also expressed a policy concern that without a cessation of business rule, a taxpayer could restructure its businesses in a manner to omit income resulting from change in accounting methods, thus contravening Section 481(a). A taxpayer could also completely liquidate and forgo inclusion of the balance. Though Hospital Corporation argues that general principles of taxation attribute additions to income to the taxpayer and not to the taxpayer's asset (*e.g.*, its hospitals), and that other tax provisions would prevent the taxpayer from avoiding inclusion of a previous Section 481(a) adjustment if a corporation were to dissolve, that does not establish unreasonableness of the Treasury's interpretation.

We agree with the Tax Court that the statute is ambiguous, addressing neither cessation of business nor ownership of more than one hospital. Turning to the legislative history, we find that it is unclear as well. Congress could have meant that any company operating any hospital could use only a ten-year spread, no more or no less. Or Congress could have meant to permit

application of cessation of business principles where a taxpayer no longer owns the hospitals to which the statute applied. Without a clear indication of congressional intent, we must determine if the interpretation chosen by the Treasury Department is reasonable. *See Chevron, supra.*

The interpretation of the Treasury regulation prevents distortion of income or omission of required inclusions after a business ceases to operate, either by liquidating entirely or disposing of a subsidiary business. We agree with the Tax Court's reasoning to the effect that Treasury Regulation 1.448- 1(g) represents a permissible interpretation of Section 481(a) of the Internal Revenue Code.

The judgment of the Tax Court is AFFIRMED.

UNITED STATES TAX COURT

HOSPITAL CORPORATION OF AMERICA & SUBSIDIARIES,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Nos. 10663-91, 13074-91, 28588-91, 6351-92

Sept. 17, 1996

WELLS, Judge.

These cases were consolidated for purposes of trial, briefing, and opinion and will hereinafter be referred to as the instant case.[1] Respondent determined deficiencies

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[1] The instant case involves several issues, some of which have been settled. The issues remaining to be decided involve matters that may be classified into four reasonably distinct categories, which the parties have denominated the tax accounting issues, the MACRS depreciation issue, the HealthTrust issue, and the captive insurance or Parthenon Insurance Co. issues. Issues involved in the first three categories were presented at a special trial session, and the captive insurance issues were severed for trial purposes and were presented at a subsequent special trial session. Separate briefs of the parties were filed for each of the distinct categories of issues. In a Memorandum Opinion issued Mar. 7, 1996, *Hospital Corp. of Am. v. Commissioner*, T.C. Memo. 1996-105, and an Opinion issued Sept. 12, 1996, *Hospital Corp. of Am. v. Commissioner*, 107 T.C. 73 (1996), we addressed two of the tax accounting issues. The instant Opinion addresses the last of the tax accounting issues and specifically involves taxable years ended 1987 and 1988, which were not involved

in petitioners' consolidated corporate Federal income tax as shown below.

TYE	*Deficiency*
1978	$2,187,079.00
1980	388,006.58
1981	94,605,958.92
1982	29,691,505.11
1983	43,738,703.50
1984	53,831,713.90
1985	85,613,533.00
1986	69,331,412.00
1987	294,571,908.00
1988	25,317,840.00

Respondent also determined that the provision for increased interest pursuant to section 6621(c) applied. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

The issue to be decided in the instant opinion is what amount, if any, petitioners may exclude from income for taxable years ended 1987 and 1988 pursuant to the nonaccrual-experience method.

FINDINGS OF FACT

Some of the facts have been stipulated for trial pursuant to Rule 91. We incorporate those stipulated facts herein by reference and find them as facts herein.

During the years in issue, petitioners were members of an affiliated group of corporations whose common

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in T.C. Memo. 1996-105 (but 1987 was involved in *Hospital Corp. of Am. v. Commissioner*, 107 T.C. 73 (1996)). Other issues will be addressed in one or more separate Opinions subsequently to be released.

parent was Hospital Corp. of America (HCA).[2] HCA maintained its principal offices in Nashville, Tennessee, on the date the petitions were filed. For each of the years involved in the instant case, HCA and its domestic subsidiaries filed a consolidated Federal corporate income tax return (consolidated return) on Form 1120 with the Director of the Internal Revenue Service Center at Memphis, Tennessee.

Petitioners' primary business is the ownership, operation, and management of hospitals. A detailed description of petitioners' hospital operations is set forth in *Hospital Corp. of America v. Commissioner*, T.C. Memo. 1996-105, most of which will not be reiterated here. Our findings of fact contained in that memorandum opinion are incorporated herein.

For taxable years ended before January 1, 1987, some petitioner hospitals used the *Black Motor* formula[3] to determine the portion of their yearend accounts receivable that was unlikely to be collected. Those hospitals established reserves for bad debts (bad debt reserves) and, based on the *Black Motor* determinations, for years ended prior to 1987 they deducted additions to the bad debt reserves as ordinary business expenses in accordance with section 166(c).[4] In audits of petitioners'

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[2] On Feb. 10, 1994, HCA was merged with and into Galen Healthcare, Inc., a subsidiary of Columbia Healthcare Corp. of Louisville, Kentucky, and the subsidiary changed its name to HCA-Hospital Corp. of America. On that same date, the parent changed its name to Columbia/HCA Healthcare Corp.

[3] The *Black Motor* formula is based on a method for computing additions to a reserve for bad debts that was described initially in *Black Motor Co. v. Commissioner*, 41 B.T.A. 300 (1940), affd. on another issue 125 F.2d 977 (6th Cir. 1942).

[4] Sec. 166(c), which was repealed by sec. 805(a) of the Tax Reform Act of 1986 (TRA), Pub.L. 99-514, 100 Stat. 2361, provided that an

Federal income tax returns for years ended prior to 1987, respondent did not contend that the *Black Motor* formula employed by those petitioners incorrectly reflected the hospitals' bad debt experience. In some instances, respondent's agents required petitioners not using the *Black Motor* formula to employ that formula to compute their bad debt reserves. In accordance with the repeal of section 166(c), effective for the year ended 1987, petitioners could use only the specific charge-off method to deduct bad debts. Tax Reform Act of 1986, Pub. L. 99-514, sec. 805, 100 Stat. 2361-2362.

With the consolidated return for taxable year ended 1987, petitioners timely filed an application on Form 3115, Application for Change In Accounting Method, to elect the so-called nonaccrual-experience method[5] for taxable

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accrual method taxpayer generally could deduct a reasonable addition to a reserve for bad debts in lieu of the specific charge-off of wholly or partially worthless debts provided by sec. 166(a). Congress repealed sec. 166(c) because it believed that allowing deductions for losses that statistically occur in the future was inconsistent with the treatment of other deductions under the all events test inasmuch as allowance of the deduction before the losses occurred permitted a deduction that was larger than the present value of the losses. See H. Rept. 99-426, at 577 (1985), 1986-3 C.B. (Vol. 2) 1, 577; S. Rept. 99-313, at 155 (1986), 1986-3 C.B. (Vol. 3) 1, 155. Pursuant to TRA sec. 805(a), 100 Stat. 2362, the positive sec. 481(a) adjustment relating to the repeal of the reserve method of accounting for bad debts was to be accounted for ratably over a 4-year spread period commencing with the year ended 1987.

[5] The nonaccrual-experience method provides that an accrual-method taxpayer generally does not have to accrue as gross income at the time the taxpayer normally would be required to recognize income with respect to an account receivable (i.e., at the time all events had occurred to fix the right to receive the income and the amount could be determined with reasonable accuracy) accounts receivable relating to services performed by the taxpayer that, based on experience, the taxpayer will not collect. Sec. 448(d)(5). See *infra* pp. 126-128 for a detailed description of the nonaccrual-experience

year ended 1987. Petitioners elected to use the periodic system[6] of the nonaccrual-experience method to estimate on a hospital-by-hospital basis the portion of their income they would not collect (sometimes hereinafter referred to as the uncollectible amount), except that petitioners computed the uncollectible amount by using the formula (original formula)[7] set forth in section 1.448-2T(e)(2)(i), Temporary Income Tax Regs., 52 Fed. Reg. 22775 (June 16, 1987) (original temporary regulations), rather than the formula (amended formula) set forth in amended section 1.448- 2T(e)(2), Temporary Income Tax Regs., 53 Fed. Reg. 12513-12514 (Apr. 15, 1988) (amended temporary regulations). Hereinafter, we sometimes will refer to the method petitioners used to compute the uncollectible amount for years ended 1987 and 1988 as the modified periodic system.

For taxable years ended 1987 and 1988, petitioners reduced (or increased) income of each hospital by the sum of (1) net writeoffs of bad debts (i.e., total bad debts written off during the year less any recoveries) and (2) the annual increase or decrease in the aggregate uncollectible amount (i.e., the aggregate amount that petitioners estimated would not be collected on accounts receivable outstanding at yearend) computed on the basis of the modified periodic system. Respondent agrees that

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method. Pursuant to sec. 1.448-2T(h)(1), Temporary Income Tax Regs., 52 Fed. Reg. 22776 (June 16, 1987), consent to a change to the nonaccrual-experience method is granted automatically if the taxpayer is qualified to use that method.

[6] The periodic system of the nonaccrual-experience method, described in Notice 88-51, 1988-1 C.B. 535, is similar to a reserve system. See *infra* pp. 127-128 for a detailed description of the periodic system.

[7] The parties agree that the original formula is identical to the *Black Motor* formula.

petitioners' reductions for net writeoffs of bad debts were proper but does not agree with petitioners' computation of the aggregate uncollectible amount.

For each petitioner qualified to use the nonaccrual-experience method, petitioners computed the amount of the negative section 481(a) adjustment relating to the change to that method to be equal to the uncollectible amount as of December 31, 1986, as calculated under the modified periodic system.[8] In the case of those petitioners that had employed an overall accrual method of accounting for taxable years ended prior to January 1, 1987, each petitioner's negative section 481(a) adjustment relating to the change to the nonaccrual-experience method for taxable years ended 1987 and 1988 equaled the amount of the net positive section 481(a) adjustment relating to the repeal of the reserve method of accounting for those years.

In the case of those petitioners that had employed the hybrid method of accounting for taxable years ended prior to January 1, 1987, to the extent that the uncollectible amount was attributable to the use of the cash method for taxable years ended prior to January 1, 1987, each qualified petitioner reduced taxable income for each of the years ended 1987 and 1988 by one-tenth of the portion of accounts receivable estimated to be uncollectible as of December 31, 1986, using the modified periodic system. To the extent that the uncollectible amount was attributable to the use of an accrual method for taxable years ended prior to January 1, 1987, the

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[8] In other words, petitioners calculated the portion of accounts receivable that would not be collected by multiplying yearend accounts receivable by the ratio of writeoffs for bad debts (adjusted for recoveries) for the current year and the 5 preceding years over the sum of the yearend accounts receivable balances for the same 6-year period.

uncollectible amount was equal to the net positive section 481(a) adjustment relating to the repeal of the reserve method of accounting for bad debts. As calculated by petitioners, for taxable years ended 1987 and 1988 the negative section 481(a) adjustment relating to the election of the nonaccrual-experience method was equal to the positive section 481(a) adjustment relating to the repeal of the reserve method of accounting for bad debts.

On audit, respondent disallowed all reductions in petitioners' taxable income attributable to the use of the nonaccrual-experience method, other than net writeoffs of bad debts for each year, on the grounds that petitioners had failed to provide documentation needed to compute the portion of petitioners' income earned from the performance of services and that they had not used the proper formula in applying the nonaccrual-experience method. Respondent's adjustments had the effect of disallowing petitioners' negative section 481(a) adjustment attributable to the election of the nonaccrual-experience method, but leaving unchanged the positive section 481(a) adjustment attributable to the repeal of the reserve method of accounting for bad debts. Accordingly, respondent's adjustments increased petitioners' income for each of the years ended 1987 and 1988 by one-fourth of the positive section 481(a) adjustment attributable to the repeal of the reserve method of accounting for bad debts.

As calculated pursuant to the *Black Motor* formula, for taxable years ended 1987 and 1988, without taking into account the impact of the resolution of other issues raised in the notice of deficiency, the percentage of petitioners' yearend accounts receivable not accrued in income under the nonaccrual-experience method are 19.94 percent and 20.62 percent, respectively.

On their consolidated return for the taxable year ended 1987 as originally filed, HCA, as parent of the affiliated group, added $20 million to their consolidated income, and thereby reduced by that amount the aggregate uncollectible amount as determined under the modified periodic system. Petitioners added the $20 million to their consolidated income to account for possible future corrections or adjustments to their nonaccrual-experience method computations following the issuance of final regulations or on audit. In an amended consolidated return for the taxable year ended 1987 (amended return) filed September 9, 1991, HCA claimed that it was entitled to reduce consolidated income, and thereby increase the aggregate uncollectible amount, by $20 million. On audit, respondent allowed the claimed $20 million reduction in consolidated income by offsetting the nonaccrual-experience method adjustment by that amount.

In the amended return, HCA also claimed that petitioners were entitled to a refund of tax based on a computational adjustment in the application of the nonaccrual-experience method for certain petitioners whose stock was sold, or whose assets were transferred to a subsidiary whose stock was sold, to HealthTrust, Inc.—The Hospital Corporation (HealthTrust) in September 1987. On petitioners' original return, the original formula was applied to those petitioners by using the accounts receivable as of the date of sale and by using the net writeoffs of bad debts from January 1, 1987, through the date of sale. In the amended return, the computation was made by annualizing the net writeoffs of bad debts for the period from January 1, 1987, through the date of the sale, thus increasing the uncollectible amount for the taxable year 1987 by $7,366,123.

Petitioners do not charge or otherwise require interest to be paid on their accounts receivable, they do not charge or otherwise impose any penalties for failing to pay an account receivable timely, and no portion of their accounts receivable was owed on account of activities with respect to either (1) lending money or (2) acquiring receivables or other rights to receive payment from other persons.

Petitioner's hospitals make frequent use of various medical and surgical supply items and pharmaceuticals (hereinafter sometimes collectively referred to as medical supplies) in providing medical care to patients. Many of the medical supplies are used directly on a patient by a physician in the performance of a medical procedure, and others are used by nurses, attendants, and other medical personnel in the treatment of the patient. The quantities of items used, administered, or consumed and the timing of such use, administration, or consumption are determined by the physician or hospital staff, on some occasions after consultation with the patient.

Medical supplies may be applied to, implanted in, or otherwise administered to, furnished to, or used in connection with the treatment of patients. Examples of these medical supplies include casts, crutches, canes, walkers, bandages, sutures, splints, skin staples, various implants such as joint replacements, pacemakers, and heart valves, orthopedic devices, and physical and occupational therapy items. These items often leave the hospital with the patient, although some items such as sutures, splints, skin staples, and implants can be removed from the patient only by a physician or other trained medical personnel.

Medicines and prescription drugs frequently are administered to a patient during the course of treatment for the patient's condition. Intravenous solutions or

blood and blood derivatives also may be administered to a patient. Medical supplies, moreover, may be used in performing surgical and other procedures on patients, including such items as scalpels and other surgical instruments, sponges, surgical drapes, surgical gowns, towels, syringes, alcohol preparations, drainage and irrigating tubes, and tourniquets.

Additionally, many ancillary hospital departments use medical supplies in the course of performing their particular specialties relating to patient hospital care. For example, x-ray film, chemicals, dyes, and nuclear materials are used in the course of performing radiological diagnostic procedures. Gases are administered to patients during surgery under the strict supervision of an anesthesiologist. Oxygen is administered to patients by the respiratory therapy department. Dyes are injected in patients with possible coronary artery disease during the diagnostic procedure known as cardiac catheterization. Psychiatric facilities sometimes use other medical supplies and equipment in certain treatments, such as insulin therapy, electroshock therapy, and hydrotherapy.

The hospitals employ sophisticated medical records systems to identify which medical supplies are used on or for each patient. The hospitals determine patient charge amounts for listing on billing statements for many individual procedures involving a medical supply based on a schedule of algorithms that typically are a multiple of the cost of the supply item used or a multiple of the average wholesale price of the pharmacy item used.

At discharge, patients are furnished a summary bill that shows separate charge categories such as patient room charges, pharmacy, medical/surgical supplies, and laboratory. Upon request, the patient will receive a more detailed bill that itemizes each separate charge within the

broad categories. The items listed on summary bills vary from patient to patient based on the exact medical care received by the patient. For example, the bill often identifies charges as being for the use of patient rooms and for various special areas, such as the operating room, recovery room, delivery room, nursery, emergency room, or intensive care unit. The bill also may identify charges for ancillary procedures such as radiology, anesthesia, nuclear medicine, various laboratory procedures, inhalation therapy, and physical therapy. Some specific charges on the detailed bill are identified by the name and/or code of a particular medication, supply item, or IV solution used in providing medical services to the patient.

Public or private insurance programs directly or indirectly pay 70 and 80 percent of the hospitals' bills to patients. Those insurance programs calculate payments to the hospitals on a flat amount based on a particular procedure or on some other negotiated per-case or per diem basis. Thus, in most cases, the hospitals' itemized bills do not bear any particular relationship to the amounts that the hospitals actually will be paid for the services provided. See *Hospital Corp. of Am. v. Commissioner*, T.C. Memo. 1996-105, for a detailed description of the hospitals' billing practices and the insurers' payment policies.

OPINION

An accrual method taxpayer generally must include a taxable amount in income when all events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. Sec. 1.451-1(a), Income Tax Regs. Section 448(d)(5),[9] however,

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[9] Sec. 448(d)(5) provides as follows:

provides that an accrual-method taxpayer is not required to accrue income earned by the taxpayer with respect to the performance of services which, based on experience, it will not collect (i.e., the uncollectible amount) and for which no interest is charged or no penalty is applied for overdue receivables. The nonaccrual-experience method is treated as a method of accounting. Sec. 1.448-2T(b), Temporary Income Tax Regs., 52 Fed. Reg. 22774-22775 (June 16, 1987).

The Positions of the Parties

Petitioners contend that the amended temporary regulations are invalid because they are inconsistent with the plain meaning of section 448(d)(5). Petitioners maintain that Congress expressly authorized use of the *Black Motor* formula to compute the uncollectible amount. Additionally, petitioners contend that their accounts receivable are derived entirely from the performance of services and, as a result, the uncollectible amount should be determined with respect to all of their accounts receivable. Petitioners further assert that, for those petitioners which had short taxable years for 1987 because their stock was sold, the *Black Motor* formula must be applied in conjunction with the periodic system by annualizing the writeoffs of bad debts to avoid a distortion for that year.

Respondent contends, on the other hand, that the Amended Formula is taken directly from the legislative history of section 448 and is consistent with the statute's

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(5) SPECIAL RULE FOR SERVICES. — In the case of any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person, such person shall not be required to accrue any portion of such amounts which (on the basis of experience) will not be collected. This paragraph shall not apply to any amount if interest is required to be paid on such amount or there is any penalty for failure to timely pay such amount.

plain language, origin, and purposes. Respondent maintains that the amended regulations are a valid interpretation of congressional intent and properly compute the uncollectible amount. Additionally, respondent contends that the hospitals sell substantial amounts of medical supplies to their patients in addition to performing services. Respondent maintains that petitioners' records do not properly allocate accounts receivable between income earned from the sale of services and income earned from the sale of inventory; therefore, petitioners cannot use the nonaccrual-experience method because they cannot establish the portion of their income that is derived solely from the performance of services.

The question is one of first impression.

The Nonaccrual-Experience Method Formula

The temporary regulations apply the nonaccrual-experience method formula to each separate trade or business of a taxpayer. Sec. 1.448-2T(e)(1), Temporary Income Tax Regs.,[10] 52 Fed. Reg. 22775 (June 16, 1987).

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[10] Sec. 1.448-2T(e), Temporary Income Tax Regs., as amended, provides in pertinent part as follows:

(e) *Use of experience to estimate uncollectible amounts*—(1) *In general.* In determining the portion of any amount due which, on the basis of experience, will not be collected, the formula prescribed by paragraph (e)(2) of this section shall be used by the taxpayer with respect to each separate trade or business of the taxpayer. No other method or formula may be used by a taxpayer in determining the uncollectible amounts under this section.

(2) *Six-year moving average*--(i) *General rule.* For any taxable year the uncollectible amount of a receivable is the amount of that receivable which bears the same ratio to the account receivable outstanding at the close of the taxable year as (A) the total bad debts (with respect to accounts receivable) sustained throughout the period consisting of the taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted

No other method or formula may be used to calculate the uncollectible amount pursuant to the temporary regulations. *Id.*

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for recoveries of bad debts during such period, bears to (B) the sum of the accounts receivable earned throughout the entire six (or fewer) taxable year period (i.e., the total amount of sales resulting in accounts receivable) throughout the period. Accounts receivable described in paragraphs (c) [any amounts due for which interest or penalties are charged] and (d) [any amounts not earned by the taxpayer for services performed by the taxpayer] of this section are not taken into account in computing the ratio.

(ii) *Period of less than six years.* A period shorter than six years generally will be appropriate only if there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially increased. * * *

* * * * *

(3) *Mechanics of nonaccrual-experience method.* The nonaccrual-experience method shall be applied with respect to each account receivable of the taxpayer which is eligible for such method. With respect to a particular account receivable, the taxpayer will determine, in the manner prescribed in paragraph (e) of this section, the amount of such account receivable that is not expected to be collected. Such determination shall be made only once with respect to each account receivable, regardless of the term of such receivable. The estimated uncollectible amount shall not be recognized as gross income. Thus, the amount recognized as gross income shall be the amount that would otherwise be recognized as gross income with respect to the account receivable, less the amount which is not expected to be collected. Upon the collection of the account receivable, additional gross income shall be recognized with respect to the collection of any amount not initially expected to be collected. Similarly, no bad debt deduction under section 166 for a wholly or partially worthless account receivable shall be allowed for any amount not previously taken into income under the nonaccrual-experience method.

[Sec. 1.448-2T(e), Temporary Income Tax Regs., 52 Fed. Reg. 22774-22775 (June 16, 1987), as amended by T.D. 8194, 1988-1 C.B. 186.]

The Separate Receivable System of the Nonaccrual-Experience Method

The so-called separate receivable system provided in the temporary regulations applies the nonaccrual-experience method to each account receivable which is eligible for that method. Sec. 1.448-2T(e)(3), Temporary Income Tax Regs., 52 Fed. Reg. 22775 (June 16, 1987). For any eligible receivable, the taxpayer includes in gross income only the amount of that receivable that is recognized as gross income minus the uncollectible amount. The uncollectible amount of any receivable is the amount of the receivable outstanding at the close of the taxable year multiplied by a percentage. The amended formula provides for the determination of the percentage by dividing (a) total bad debts (adjusted for recoveries) sustained during the current and 5 preceding taxable years (or a shorter period with the approval of the Commissioner) by (b) the sum of the accounts receivable earned throughout that same 6-year (or shorter) period. Accordingly, the amended formula provides for the determination of the denominator of the fraction on the basis of total sales resulting in accounts receivable throughout the applicable period. Sec. 1.448-2T(e)(2)(i), Temporary Income Tax Regs., 53 Fed. Reg. 12513-12514 (Apr. 15, 1988). A taxpayer which has been in existence for less than 6 years is to use its experience for the current year and the actual number of preceding taxable years. The taxpayer may use a predecessor's experience from preceding taxable years. Sec. 1.448-2T(e)(2)(iii), Temporary Income Tax Regs., 52 Fed. Reg. 22775 (June 16, 1987).

The separate receivable system provides for the determination of the uncollectible amount only once for each account receivable, regardless of the term of that receivable. Sec. 1.448-2T(e)(3), Temporary Income Tax

Regs., *supra*. As each receivable is collected, income is reported only to the extent not previously accrued. If a receivable is not collected, the bad debt deduction is limited to the amount previously reported as income. *Id.*

The Periodic System of the Nonaccrual-Experience Method

Alternatively, a taxpayer may elect the so-called periodic system for applying the nonaccrual-experience method. Notice 88-51, 1988-1 C.B. 535; see H. Rept. 99-426, at 608 (1985), 1986-3 C.B. (Vol. 2) 1, 608. The periodic system requires a taxpayer to establish an account which represents the aggregate amount of accounts receivable in a trade or business eligible for the nonaccrual-experience method that the taxpayer estimates will not be collected, based on the 6-year moving average formula set forth in section 1.448-2T(e)(2)(i), Temporary Income Tax Regs., *supra*, and Notice 88-51, 1988-1 C.B. at 536. At yearend, the taxpayer adjusts the account to reflect the aggregate amount that the taxpayer estimates will not be collected on the accounts receivable outstanding at that time. Income is increased to reflect any decrease in the reserve balance or decreased to reflect any increase in that balance. Notice 88-51, 1988-1 C.B. at 536. Accordingly, the periodic system of the nonaccrual-experience method of accounting is somewhat similar to a reserve method. *Id.*

The periodic system requires the taxpayer to charge wholly or partially worthless accounts receivable directly to bad debt expense, ignoring the uncollectible amounts pertaining to those accounts receivable. Similarly, the taxpayer must disregard the uncollectible amounts of accounts receivable when it accounts for the collection of those receivables. *Id.* The 6-year moving average formula is used to estimate the total amount of all eligible accounts receivable outstanding at yearend that the taxpayer estimates it will not collect, including accounts

receivable outstanding at the end of prior taxable years. *Id.*

Is Section 448(d)(5) Ambiguous?

Petitioners contend that the amended regulations are invalid because they are an unreasonable interpretation of an unambiguous statutory provision. In response, respondent contends that the statute is ambiguous in that it does not specify how "experience" is to be determined. Respondent contends further that the amended regulations are a valid interpretation of the statute.

In construing section 448(d)(5) our task is to give effect to the intent of Congress. We begin with the statutory language, which is the most persuasive evidence of the statutory purpose. *United States v. American Trucking Associations, Inc.*, 310 U.S. 534, 542-543 (1940); *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 93-94 (1934); *General Signal Corp. & Subs. v. Commissioner*, 103 T.C. 216, 240 (1994), supplemented by 104 T.C. 248 (1995). Ordinarily, the plain meaning of statutory language is conclusive. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241-242 (1989).

Where a statute is silent or ambiguous, we look to legislative history in an effort to ascertain congressional intent. *Burlington No. R.R. v. Oklahoma Tax Commn.*, 481 U.S. 454, 461 (1987); *United States v. American Trucking Associations, Inc., supra* at 543-544; *Peterson Marital Trust v. Commissioner*, 102 T.C. 790, 799 (1994), affd. 78 F.3d 795 (2d Cir. 1996); *U.S. Padding Corp. v. Commissioner*, 88 T.C. 177, 184 (1987), affd. 865 F.2d 750 (6th Cir. 1989). Even where the statutory language appears to be clear, we are not precluded from consulting legislative history. *United States v. American Trucking Associations, Inc., supra* at 543-544. Nevertheless, our authority to construe a statute is limited where the agency charged with administering that statute has promulgated regulations thereunder.

The limitation on our authority is found in the so-called *Chevron* rule as stated in the following passage:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute. [*Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-843 (1984); fn. refs. omitted.]

See also *NationsBank v. Variable Annuity Life Ins. Co.*, 513 U.S. ___, 115 S. Ct. 810, 813 (1995); *Pension Benefit Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 647-648 (1990). The Supreme Court further has stated that a reviewing court

> need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding.

[*Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., supra* at 843 n.11; citations omitted.]

Accordingly, "If the administrator's reading fills a gap or defines a term in a way that is reasonable in light of the legislature's revealed design, we give the administrator's judgment 'controlling weight.'" *NationsBank v. Variable Annuity Life Ins. Co.*, 513 U.S. at ___, 115 S. Ct. at 813-814. Despite the fact that the *Chevron* rule "has had a checkered career in the tax arena", *Central Pa. Sav. Association v. Commissioner*, 104 T.C. 384, 391-392 (1995), the Court of Appeals for the Sixth Circuit, to which an appeal of the instant case would lie absent stipulation of the parties to the contrary, has stated that where "Congress has not directly spoken to the precise question at issue, the [*Chevron*] rule *** should be applied". *Peoples Fed. Sav. & Loan Association v. Commissioner*, 948 F.2d 289, 299 (6th Cir. 1991), revg. T.C. Memo. 1990-129. "If there are gaps left by silence or ambiguity of the statutes in question, agencies may fill the gaps with necessary rules, providing they are reasonable, and courts should not interfere with this process." *Id.* at 300.

Petitioners maintain that the phrase "on the basis of experience" is not defined in the statute and that Congress did not delegate to the Commissioner the authority to define the phrase. Petitioners assert further that no definition is necessary because the phrase is not ambiguous and must be interpreted in accordance with its plain, everyday meaning. We conclude, however, that the phrase is ambiguous.

The words in a revenue act generally should be interpreted in their ordinary, everyday sense. *Commissioner v. Soliman*, 506 U.S. 168, 174 (1993). Webster's II New Riverside University Dictionary (1984) defines "experience" as "An event or series of events

participated in" or "The totality of such events in the past of an individual or group." We do not find in that definition a clear mechanism for determining how a taxpayer's bad debt experience will be utilized to calculate the uncollectible portion of a receivable. The statute on its face, furthermore, provides no formula for calculating that amount. Petitioners, however, in essence argue that, when the Code employs the word "experience" in conjunction with bad debts, the word has a predetermined meaning which prescribes the formula that must be used to calculate the uncollectible portion of an amount owed a taxpayer.

In that regard, petitioners contend that Congress explicitly recognized that the term "experience" as it relates to bad debt experience is synonymous with the *Black Motor* formula. We have found no cases, and petitioners have cited none, where the term "experience" was found to have the technical meaning advanced by petitioners. Moreover, section 448 does not define the word in that manner. In support of their contention petitioners cite section 585(b)(2),[11] which describes "the

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[11] Sec. 585, as amended by sec. 11801(c)(12) of the Omnibus Budget Reconciliation Act of 1990, Pub.L. 101-508, 104 Stat. 1388-527, provides in pertinent part as follows:

SEC. 585. RESERVES FOR LOSSES ON LOANS OF BANKS.

(a) RESERVE FOR BAD DEBTS.—

(1) IN GENERAL.—Except as provided in subsection (c), a bank shall be allowed a deduction for a reasonable addition to a reserve for bad debts. Such deduction shall be in lieu of any deduction under section 166(a).

* * *

(b) ADDITION TO RESERVES FOR BAD DEBTS.—

(1) GENERAL RULE.—For purposes of subsection (a), the reasonable addition to the reserve for bad debts of any financial institution to which this section applies shall be an amount determined by the taxpayer which shall not exceed the addition

experience method" that qualified banks use to determine the maximum amount they may add to their reserves for bad debts. Petitioners assert, and respondent does not dispute, that the experience method described in section 585(b)(2) and section 1.585-2(c)(1), Income Tax Regs., is identical to the *Black Motor* formula.

Petitioners seemingly would have us conclude from the foregoing that the word "experience" in section 448(d)(5) has the same meaning as the term "experience method" in section 585. We, however, do not agree that Congress' use of the word "experience" in section

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to the reserve for losses on loans determined under the experience method as provided in paragraph (2).

(2) EXPERIENCE METHOD.—The amount determined under this paragraph for a taxable year shall be the amount necessary to increase the balance of the reserve for losses on loans (at the close of the taxable year) to the greater of—

(A) the amount which bears the same ratio to loans outstanding at the close of the taxable year as (i) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Secretary, a shorter period), adjusted for recoveries of bad debts during such period, bears to (ii) the sum of the loans outstanding at the close of such 6 or fewer taxable years, or

(B) the lower of—

(i) the balance of the reserve at the close of the base year, or

(ii) if the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve at the close of the base year bears to the amount of loans outstanding at the close of the base year.

For purposes of this paragraph the base year shall be the last taxable year before the most recent adoption of the experience method, except that for taxable years beginning after 1987 the base year shall be the last taxable year beginning before 1988.

448(d)(5) necessarily shows congressional intent that the uncollectible amount be calculated under the *Black Motor* formula. Indeed, we think that it is more probable that, if Congress had intended the same formula to apply in section 448(d)(5) and in section 585, then it would have specified that the uncollectible amount be based on "the experience method" or on "the *Black Motor* formula". The use of the word "experience" in section 448(d)(5) and the words "experience method" in section 585 may reasonably be viewed as an indication of two different meanings. Cf. *Norfolk S. Corp. v. Commissioner*, 104 T.C. 13, 38-41 (1995).

In sum, we do not find that the statutory language manifests congressional intent as to what method is to be employed to calculate the uncollectible amount, and we conclude that section 448(d)(5) is ambiguous as to the meaning of "experience". We next look to the statute's legislative history in an attempt to ascertain congressional intent.

Does the Legislative History Clearly Reveal Congressional Intent as to the Formula To Apply?

Petitioners maintain that the legislative history of section 448(d)(5) does not clearly reveal Congress' intent as to the proper formula to apply. A description of the nonaccrual-experience method formula is contained only in the report of the Committee on Way and Means.[12] Because that report contains conflicting language, we do not think it clearly describes the formula. H. Rept. 99-426, at 608 (1985), 1986-3 C.B. (Vol. 2) 1, 608, states in pertinent part as follows:

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[12] A provision comparable to sec. 448(d)(5) was not present in the Senate amendment, and the conference report does not describe the nonaccrual-experience method formula. See H. Conf. Rept. 99-841 (Vol. 2), at II-285 to II-289 (1986), 1986-3 C.B. (Vol. 4) 1, 285-289.

Amount of accrual

The committee bill provides that an accrual basis taxpayer need not accrue as income any portion of amounts billed for the performance of services which, on the basis of experience, it will not collect. * * *

The amount of billings that, on the basis of experience, *will not be collected is equal to the total amount billed, multiplied by a fraction whose numerator is the total amount of such receivables which were billed and determined not to be collectible within the most recent five years taxable years [sic] of the taxpayer, and whose denominator is the total of such amounts billed within the same five year period.* If the taxpayer has not been in existence for the prior five taxable years, the portion of such five year period which the taxpayer has been in existence is to be used.

For example, assume that an accrual-basis taxpayer has $100,000 of receivables that have been created during the most recent five taxable years. Of the $100,000 of accounts receivable, $1,000 have been determined to be uncollectible. *The amount, based on experience, which is not expected to be collected is equal to 1 percent ($1,000 divided by $100,000) of any receivable arising from the provision of services that are outstanding at close of the taxable year.*

[Emphasis added; fn. ref. omitted.]

As the foregoing emphasized language reveals, one paragraph of the committee report specifies that the uncollectible amount is calculated by multiplying the *total amount billed* during the taxable year by the ratio of the

sum of the amount of those billings determined uncollectible within the most recent 5 taxable years to the sum of the billings within that same 5-year period. In the example in the following paragraph, however, the formula is expressed somewhat differently; to wit, in the example, the uncollectible amount is calculated by multiplying the *receivables outstanding at the close of the taxable year* by the ratio of the amount of those billings determined uncollectible within the most recent 5 taxable years to the sum of the billings within that same 5-year period. In our view, the committee report merely suggests that Congress intended eligible taxpayers to employ a method to determine statistically the uncollectible amount that was similar, but not identical, to the *Black Motor* formula. Consequently, we do not find the legislative history to clearly reveal Congress' intent as to the method of calculating the uncollectible amount. In the absence of a clear indication of congressional intent on the precise question in issue, our next task is to decide whether the temporary regulations[13] promulgated under section 448(d)(5) are a permissible construction of the statute.

Are the Amended Regulations a Permissible Construction of the Statute?

To be valid, section 1.448-2T(e)(2)(i), Temporary Income Tax Regs., 53 Fed. Reg. 12513-12514 (Apr. 15, 1988), need not be the only, or even the best, construction of section 448(d)(5). Rather, the amended regulations need only be a reasonable interpretation of congressional

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[13] Temporary regulations are entitled to the same weight as final regulations. *Peterson Marital Trust v. Commissioner*, 102 T.C. 790, 797 (1994), affd. 78 F.3d 795 (2d Cir. 1996); see also *Truck & Equip. Corp. v. Commissioner*, 98 T.C. 141, 149 (1992); *Nissho Iwai Am. Corp. v. Commissioner*, 89 T.C. 765, 776 (1987); *Zinnel v. Commissioner*, 89 T.C. 357, 369 (1987).

intent. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. at 843; *Peoples Fed. Sav. & Loan Association v. Commissioner*, 948 F.2d at 299-300. "The choice among reasonable interpretations is for the Commissioner, not the courts." *National Muffler Dealers Association v. United States*, 440 U.S. 472, 488 (1979); see also *United States v. Correll*, 389 U.S. 299, 306-307 (1967); *Udall v. Tallman*, 380 U.S. 1, 16-17 (1965).

The original formula as promulgated in section 1.448-2T(e)(2)(i), Temporary Income Tax Regs., 52 Fed. Reg. 22775 (June 16, 1987), used the *Black Motor* formula to determine the uncollectible amount.[14] The original formula provides that the uncollectible amount would be calculated as follows:

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[14] As originally promulgated, sec. 1.448-2T(e)(2)(i), Temporary Income Tax Regs., read as follows:

(2) *Six-year moving average*—(i) *General rule.* For any taxable year the uncollectible amount of a receivable is the amount which bears the same ratio to the accounts receivable outstanding at the close of the taxable year as (A) the total bad debts with respect to accounts receivable sustained during the period consisting of the taxable year and the five preceding taxable years (or with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the accounts receivable at the close of such six (or fewer) taxable years. Accounts receivable described in paragraphs (c) [amounts due for which interest is required to be paid, or for which there is any penalty for failure to timely pay any amounts due] and (d) [accounts receivables related to amounts not earned by the taxpayer through the performance of services by the taxpayer] of this section are not taken into account in computing the ratio. [Sec. 1.448-2T(e)(2)(i), Temporary Income Tax Regs., 52 Fed.Reg. 22775 (June 16, 1987)].

$$\text{Uncollectible amount of a receivable} = \text{Accounts receivable outstanding at yearend} \times \frac{\text{Total bad debts with respect to accounts receivable sustained during the current tax year and 5 preceding tax years less recoveries of bad debts during that period}}{\text{Sum of the accounts receivable at yearend for the same 6-year period}}$$

In contrast, the amended formula promulgated in section 1.448-2T(e)(2)(i), Temporary Income Tax Regs., *supra*, provides for the uncollectible amount to be calculated as follows:

$$\text{Uncollectible amount of a receivable} = \text{Accounts receivable outstanding at yearend} \times \frac{\text{Total bad debts with respect to accounts receivable sustained during the current tax year and 5 preceding tax years less recoveries of bad debts during that period}}{\text{Sum of accounts receivable earned (i.e., total sales) for the same 6-year period}}$$

The substantive difference between the original formula and the amended formula is the substitution in the denominator of the multiplier of (1) the sum of *accounts receivable earned* (i.e., total sales resulting in accounts receivable) throughout the 6-year moving average period for (2) the sum of the *yearend accounts receivable* for each year during that 6-year period.

One theme recurring throughout petitioners' challenge to the validity of the amended regulations is that the amended formula is defective because it does not use the *Black Motor* formula to calculate the uncollectible amount. Neither the statute nor its legislative history, however, contains anything which leads us to conclude that Congress intended such a result.

We are not persuaded by petitioners' argument that, inasmuch as the Original Formula is premised on the *Black Motor* formula, the Secretary must have initially read the legislative history in the same manner as

suggested by petitioners. Under the circumstances of the instant case where the Secretary acted quickly—within 10 months of promulgation of the original temporary regulations—to amend temporary regulations that he concluded erroneously interpreted the statute, he was entitled to alter his interpretation of the statute on further reflection. *Rust v. Sullivan*, 500 U.S. 173, 186 (1991); *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, *supra* at 862; *Peoples Fed. Sav. & Loan Association v. Commissioner*, *supra* at 302.

The Secretary's rationale for the amendment to the nonaccrual-experience formula is revealed in the preamble to the Secretary's decision announcing the modification:

> Under the nonaccrual-experience method of accounting, the portion of a receivable that is considered uncollectible and not required to be accrued is the product of the receivable and a fraction representing the taxpayer's bad debt experience. The numerator of the fraction is the taxpayer's bad debts for the taxpayer's current and five preceding taxable years, and the denominator of the fraction is the taxpayer's accounts receivable for the same six-year period. The Internal Revenue Service has received questions from taxpayers as to whether the denominator of the fraction is determined on the basis of (i) total accounts receivable earned throughout the six-year period (i.e., the total amount of sales resulting in accounts receivable throughout the period) or (ii) yearend balances of the accounts receivable over the six-year period. These regulations

> provide that the denominator is based on total accounts receivable earned throughout the period ending at the close of the six-year period. This interpretation is consistent with the legislative history of the Act which provides that "[t]he amount of billings that, on the basis of experience, will not be collected is equal to the total amount billed, multiplied by a fraction whose numerator is the total amount of such receivables which were billed and determined not to be collectible within the most recent five taxable years of the taxpayer, and whose denominator is the total of such amounts billed within the same five year period." H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 606 (1985). [T.D. 8194, 1988-1 C.B. 186.[15]]

As shown by the foregoing statement, the Secretary reconsidered the original temporary regulations and the legislative history as a result of questions from taxpayers as to the proper formula to use to calculate the uncollectible amount which arose following release of the original temporary regulations. A review of H. Rept. 99-426, at 608 (1985), 1986-3 C.B. (Vol. 2) 1, 608, reveals that *the multiplier* delineated in the amended formula is consistent with *the multiplier* described in the committee report. Accordingly, we conclude that the Secretary's formulation of the multiplier in the amended formula is reasonable. Whether the Secretary's framing of the multiplicand is reasonable, however, requires further analysis.

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[15] Additionally, as stated above, petitioners agree that the relevant legislative history is ambiguous.

In both the original formula and the amended formula, the multiplicand is described as the accounts receivable outstanding at yearend. As we explained, however, see *supra* p. 133, the description of the multiplicand in the committee report is inconsistent. There, the multiplicand is defined both as *the total amount billed* and as *the receivables outstanding at the close of the taxable year.*

Petitioners contend that the amended formula compares two sets of incomparable data. They maintain that a comparison of past bad debts for the current year and 5 preceding years to past total charge transactions, which includes charge transactions that are collected in the same year billed as well as amounts not yet collected, can only predict bad debts in total current charge transactions, not in yearend receivables. According to petitioners, measuring the historical relationship between annual bad debt writeoffs (net of recoveries) and total annual charges may be appropriate for estimating the portion of annual charges that is not likely to be collected but not for purposes of estimating the portion of yearend accounts receivable that probably will not be collected. Petitioners contend that the amended formula produces incorrect results and is contrary to the language and purpose of section 448(d)(5) because it requires the hospitals to accrue as income amounts which, based on experience, they will not collect.[16]

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[16] According to petitioners, their tax department calculated that petitioners' actual bad debt experience with respect to accounts receivable outstanding at the end of 1990 shows that approximately 21.4 percent of those accounts receivable was uncollectible during 1991 and 1992. Moreover, with respect to accounts receivable outstanding as of specified dates in 1987, approximately 19 percent of those receivables was uncollectible within a period of 1 year, and approximately 22 percent to 24 percent would become uncollectible

Petitioners assert that the *Black Motor* formula reasonably reflects their bad debt experience and should be applied in the instant case. Petitioners maintain that the *Black Motor* formula was intended to provide an estimate of future uncollectibility based on the taxpayer's actual recent collection experience. They assert that the *Black Motor* formula was merely a tool for determining a taxpayer's bad debt experience and was not mandatory for all circumstances. Petitioners contend that, to correctly apply the *Black Motor* formula, the regulations should allow modifications or departures for particular facts and circumstances. The foregoing arguments indicate that petitioners use the term "*Black Motor* formula" to mean the reserve method of accounting for bad debts that was in effect prior to repeal of section 166(c) as well as the mathematical formula specified in the case from which the method derives it name. See *Black Motor Co. v. Commissioner*, 41 B.T.A. 300, 302 (1940), affd. on another issue 125 F.2d 977 (6th Cir.1942).

As we view their position, petitioners essentially would prefer to substitute for the nonaccrual-experience method provided by Congress the reserve method of accounting for bad debts that was in effect prior to repeal of section 166(c) whereby the addition to the bad debt reserve was based on a reasonable amount determined by the taxpayer, with the reasonableness of that addition tested generally under the *Black Motor* formula. See *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 546 (1979);

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within 2 years. In contrast, petitioners contend, the Amended Formula produces exclusion ratios of between 3.4 percent and 5.3 percent of revenue for taxable year ended 1987 and between 2.6 percent and 4.0 percent of revenue for taxable year ended 1988, depending upon whether gross billings, billings net of contractual adjustments, or billings exclusive of Medicare and Medicaid billings are used to approximate annual charge transactions.

Black Motor Co. v. Commissioner, supra. That result, however, is not consistent with the statute. Nothing in the statute or the legislative history requires the uncollectible amount to equal the amount that would have been calculated pursuant to either the reserve method of accounting or under the *Black Motor* formula.

We also do not agree that the result under the amended formula is not determined on the basis of the hospitals' experience. The formula utilizes the bad debt history and accounts receivable of the hospitals, not some fictional entity.

Petitioners contend further that section 448(d)(5) does not authorize the prescription of a single formula to be used by all taxpayers. They argue that prescribing a single fixed formula is inconsistent with the notion of making a determination "on the basis of experience" and represents an inappropriate departure from the plain, everyday meaning of the language of section 448(d)(5) because it results in income being accrued on a basis other than the taxpayer's actual experience.

We do not agree with petitioners that the temporary regulation is invalid because it provides one formula to be applied by all taxpayers to determine the uncollectible amount. Although the legislative history of section 448(d)(5) is not without ambiguity as to the specific formula to be utilized, the description of the nonaccrual-experience method in the House report suggests a congressional preference for a fixed formula for calculating the uncollectible amount. See H. Rept. 99-426, at 608 (1985), 1986-3 C.B. (Vol. 2) 1, 608. The ambiguity in the legislative history does not arise because the report fails to use a fixed formula but because it describes that fixed formula in two different ways. Although the *Black Motor* formula is a conceivable method for calculating the uncollectible amount, and perhaps even a better choice, it

is not the only possible method, and it is not even one of the two versions of the formula that is described in H. Rept. 99- 426, *supra* at 608, 1986-3 C.B. (Vol. 2) at 608. Under the circumstances, we must defer to the Secretary's choice of formula if the method he selected is reasonable. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. at 843; *Peoples Fed. Sav. & Loan Association v. Commissioner*, 948 F.2d at 299-300; see also *National Muffler Dealers Association v. United States*, 440 U.S. at 488; *United States v. Correll*, 389 U.S. at 306-307.

Petitioners further argue essentially that the amended formula cannot be valid because the formula does not equal the hospitals' actual bad debt writeoff experience. We do not believe that section 448(d)(5) requires an exact matching of the uncollectible amount with a taxpayer's actual bad debt writeoff experience. A statistical approximation of the uncollectible amount determined under the prescribed formula appears to be all that was contemplated by Congress. See H. Rept. 99-426, *supra* at 608, 1986-3 C.B. (Vol. 2) at 608; H. Conf. Rept. 99-841 (Vol. 2), at II-288 (1986), 1986-3 C.B. (Vol. 4) 1, 288. As to the nonaccrual-experience method, the conference report states the following:

> *Effective date:*
>
> The provision of the conference agreement is effective for taxable years beginning after December 31, 1986. * * * Any adjustment required by section 481 as a result of such change * * * [from the cash method to the accrual method of accounting] generally shall be taken into account over a period not to exceed four years. It is the intent of the conferees that this apply to all changes resulting from the provision, including any changes

> necessitated by the rule that certain accrual taxpayers, including taxpayers presently on the accrual method of accounting, need not recognize income *on amounts statistically determined not to be collectible.* [H. Conf. Rept. 99-841 (Vol. 2), *supra* at II-288, 1986-3 C.B. (Vol. 4) at 288; emphasis added.]

In the amended formula, the multiplicand conforms to one of two multiplicands described in the legislative history. See H. Rept. 99-426, *supra* at 608, 1986-3 C.B. (Vol. 2) at 608. The amended formula, furthermore, effectuates the purpose of the statute. Accordingly, the Secretary's choice of multiplicand is a permissible construction of section 448(d)(5). Consequently, under the *Chevron* rule, we must defer to that construction. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., supra* at 843; *Peoples Fed. Sav. & Loan Association v. Commissioner, supra* at 299-300. For the foregoing reasons, we conclude that the amended temporary regulations are valid.

Is the Periodic System of the Nonaccrual-Experience Method Valid?

The periodic system of the nonaccrual-experience method is not described in section 448(d)(5) or in the legislative history. H. Rept. 99-426, *supra* at 608, 1986-3 C.B. (Vol. 2) at 608, however, specifies that "the Secretary of the Treasury may provide a periodic system of accounting for billings that, on the basis of experience, will not be collected where the periodic system results in the same taxable income as would be the case were each receivable recorded separately." In Notice 88-51, 1988-1 C.B. 535, the Commissioner published the periodic system as an alternative to the separate receivable system under section 1.448-2T(e)(3), Temporary Income Tax Regs., 53 Fed. Reg. 12513-12514 (Apr. 15, 1988).

Petitioners assert that the periodic system provided by the Commissioner uses an inappropriate formula to estimate the portion of yearend accounts receivable that a taxpayer will not collect. Petitioners argue that, to prevent an incorrect result, a formula applied to yearend accounts receivable balances must be based on the relationship of writeoffs to yearend accounts receivable balances, not the relationship of writeoffs to annual charges. Accordingly, petitioners' challenge to the periodic system is premised on their contention that the Amended Formula, on which the periodic system is based, is invalid. We already have concluded that the Amended Formula is a permissible construction of section 448(d)(5). Accordingly, we conclude that the periodic system of the nonaccrual-experience method is reasonable and, therefore, valid.

Respondent contends, however, that, inasmuch as petitioners did not follow the periodic system described in Notice 88-51, *supra*, they must use the separate receivable system described in the amended regulations. We do not agree that, under the circumstances present in the instant case, petitioners should be denied the use of the periodic system merely because they challenged the validity of the formulation of the nonaccrual-experience method formula. Nor do we read Notice 88-51, *supra*, as requiring such a result. Based on the foregoing, we conclude that petitioners may use the periodic system of the nonaccrual-experience method, but they must calculate the uncollectible amount under the amended formula, not under the original formula.

Because we conclude that the *Black Motor* formula is not mandated under section 448(d)(5), we do not address petitioners' further argument that they should be allowed to annualize the actual bad debt writeoff experience of the corporations that were sold to HealthTrust during

1987 in order to calculate properly the uncollectible amount for 1987 using the *Black Motor* formula.

To What Income Is the Formula To Be Applied?

Additionally, respondent contends that in substance the hospitals "sell" medical supplies to their patients. Respondent maintains that income attributable to such sale of medical supplies is not eligible for the nonaccrual-experience method. Respondent asserts further that petitioners' records do not adequately delineate accounts receivable arising from the sale of medical *services* from accounts receivable arising from the sale of medical *supplies* and, therefore, it is not possible to segregate the hospitals' income between income earned from the performance of services and income earned from the sale of medical supplies. As a result, respondent argues, petitioners may not utilize the nonaccrual-experience method for taxable years ended 1987 and 1988.

Petitioners counter that the nonaccrual-experience method is applicable to all of their accounts receivable because all of their income is derived from the performance of services. Alternatively, they contend that, even if a portion of their accounts receivable is derived from the sale of medical supplies, petitioners nevertheless are entitled to use the nonaccrual-experience method with respect to that portion of their income which is derived from the performance of services.

The nonaccrual-experience method is applicable only to amounts to be received for the performance of services. Sec. 448(d)(5). Neither the Code nor the regulations promulgated thereunder define what constitutes the performance of services for purposes of section 448(d)(5). Presumably, the performance of services would include activities in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. See sec. 448(d)(2) (defining a

personal service corporation for which section 448(b)(2) grants an exception to the general prohibition by section 448(a) of the use of the cash method of accounting by C corporations, partnerships which have a C corporation as a partner, and tax shelters).[17]

Relying on certain State law cases, respondent contends that the trend is to consider hospital services as part of sale transactions involving medical supplies. According to respondent: "This case law endeavors to protect the patient from defective hospital services, since the patient is unable to discern or control defective services and because physicians are depending on the hospital's services in undertaking the patient's treatment." Respondent thus asserts that any medical services accompanying a "sale" of medical supplies is part of the "sale" transaction.

Petitioners deny that the hospitals engage in the sale of medical supplies. They argue that the hospitals use medical supplies in the course of providing medical services, but they maintain that all of their income is derived from the performance of services. Petitioners contend that the business of operating hospitals is the quintessential service business. They argue that this Court recognized that principle in *St. Luke's Hosp. v. Commissioner*, 35 T.C. 236 (1960), as did the Supreme Court in *Abbott Labs. v. Portland Retail Druggists Association, Inc.*, 425 U.S. 1 (1976), and the Commissioner in the regulations. Petitioners maintain that hospitals do

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[17] For purposes of sec. 448(d)(2), the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. Sec. 1.448-1T(e)(4)(ii), Temporary Income Tax Regs., 52 Fed. Reg. 22768 (June 16, 1987). In the instant case, respondent does not deny that the hospitals perform services in the field of health.

not sell merchandise but rather acquire medical supplies for use in performing medical services.

In the instant case there is no dispute that the hospitals engage in service activities within the meaning of section 448(d)(5). Rather, the issue we must resolve is whether income attributable to medical supplies used in the course of performing those activities is ineligible for the nonaccrual-experience method of accounting merely because some part of the accounts receivable attributable to those medical supplies does not constitute income earned from the performance of services.

We find inapposite to the issue involved here the State law cases relied on by respondent. The focus of those cases is on whether strict tort liability principles should be applied to hospitals. Those cases are concerned with public policy considerations as to who should bear the loss from defective, though not negligent, services and/or products. See *McDaniel v. Baptist Memorial Hosp.*, 469 F.2d 230 (6th Cir. 1972); *Johnson v. Sears, Roebuck & Co.*, 355 F. Supp. 1065 (E.D. Wis. 1973); cf. *Perlmutter v. Beth David Hosp.*, 308 N.Y. 100, 123 N.E.2d 792, 796 (1954) ("what the complaint alleges and truly describes is not a purchase and sale of a given quantity of blood, but a furnishing of blood to plaintiff for transfusion at a stated sum, as part of, and incidental to, her medical treatment"). Whether strict tort liability applies under the laws of a particular State is not determinative as to the issue at hand, which is whether, for purposes of section 448(d)(5), medical supplies are so connected to the performance of medical services that income attributable to the medical supplies constitutes income earned from the performance of those services. We agree with petitioners that, for purposes of section 448(d)(5), medical supplies furnished in the course of rendering medical services are inseparably connected to the performance of those services and that

income attributable to medical supplies therefore constitutes income earned from the performance of services within the meaning of that section.[18]

Medical supplies play a necessary and vital role in the diagnosis, prognosis, and treatment of the hospitals' patients. In many cases, medical services can not be rendered without using medical supplies. The furnishing of medical supplies by the hospitals is merely incidental to the main purpose of rendering health care services that a patient seeks when entering a hospital. The hospitals do not acquire medical supplies for sale to patients but rather to render medical services. Moreover, under current payment arrangements between the hospitals and public and private insurers, the hospitals' bills to patients generally bear no particular relationship to the amounts that the hospitals actually will be paid for the services provided.

Patients, furthermore, do not come to the hospitals to buy medical supplies; rather, they are there primarily to

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[18] Our conclusion that income earned through the performance of services includes income relating to accounts receivable attributable to medical supplies used in the course of the diagnosis, prognosis, and treatment of the hospitals' patients is applicable in the instant case only for purposes of our construction of sec. 448(d)(5). We do not decide in this opinion, as we did not decide in our prior Memorandum Opinion, *Hospital Corp. of Am. v. Commissioner*, T.C. Memo. 1996-105, the question of whether the furnishing of medical supplies by petitioners' hospitals as a part of the rendering of services to their patients could be considered to be a sale of merchandise which must be inventoried pursuant to sec. 1.471-1, Income Tax Regs. Our conclusion here does not change the result in our prior Memorandum Opinion, given that for the years ended 1981 through 1986 petitioners' hospitals employed a hybrid method of accounting, not the cash method or an accrual method. Our holding applies equally to any accounts receivable attributable to medical supplies that are dispensed to employees or dependents of employees for their personal use.

obtain a course of treatment. In many cases patients are not even aware of all of the medical supplies that are used in the course of the medical treatment. Patients generally are concerned with the treatment and healing processes and not with the medical supplies utilized by the hospitals in rendering medical treatment. Patients do not choose which or how many medical supplies will be used by the hospitals' staffs. With a few exceptions, patients receive no tangible item that they did not have before the rendition of the medical services because the medical supplies generally are used and then discarded by the hospitals. Patients, moreover, generally do not acquire any rights over the medical supplies used by the hospitals in the normal course of the hospitals' operations of providing health care services. We conclude that for purposes of section 448(d)(5) the use of medical supplies is part of the medical services furnished patients and that the cost of those supplies is an incidental cost of the health care services provided by the hospitals. See *Potter v. James*, 499 F. Supp. 607, 611 (M.D. Ala. 1980).

We find support for our conclusion in *Abbott Labs. v. Portland Retail Druggists Association, Inc.*, 425 U.S. at 14-15. In *Abbott Labs.* a group of commercial pharmacies brought suit under the Robinson-Patman Price Discrimination Act (Robinson-Patman Act), ch. 592, 49 Stat. 1526 (1936) (current version at 15 U.S.C. secs. 13-13(b), 21(a) (1994)),[19] against 12 manufacturers of pharmaceutical products, alleging that the manufacturers sold their products to hospitals at prices lower than the prices charged commercial pharmacies for the same type

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[19] The Robinson-Patman Price Discrimination Act (Robinson-Patman Act), ch. 592, 49 Stat. 1526 (1936) (current version at 15 U.S.C. secs. 13-13(b), 21(a) (1994)), generally made it illegal for a seller of merchandise to discriminate in price among different purchasers of like commodities.

of products. The manufacturers countered that sales to the hospitals were exempt from the Robinson-Patman Act under the Nonprofit Institutions Act, ch. 283, 52 Stat. 446 (1938) (current version at 15 U.S.C. sec. 13(c) (1994)), which exempts from the application of the Robinson-Patman Act "purchases of their supplies for their own use by * * * hospitals and charitable institutions not operated for profit." Accordingly, the issue in the *Abbott Labs.* case was whether the pharmaceutical products were sold to the hospitals for resale or for the hospitals' "own use". The Supreme Court specifically recognized that the purchase of drugs for the treatment of a hospital's patients is a purchase for that hospital's "own use" because such use is part of and promotes the hospital's basic function of caring for patients. *Abbott Labs. v. Portland Retail Druggists Association, Inc., supra* at 10, 14; see also *St. Luke's Hosp. v. Commissioner*, 35 T.C. at 238 (taxpayer hospital is "not a merchandising business and * * * [taxpayer] has no merchandise inventories which would require the use of an accrual method in keeping its books or reporting its income. Its income is derived from providing hospital and professional care to the sick.").

We conclude from the foregoing that, for purposes of section 448(d)(5), income earned through the performance of services includes income relating to accounts receivable attributable to medical supplies used in the course of the diagnosis, prognosis, or treatment of the hospitals' patients. Cf. secs. 1.448-1T(e)(4), 1.448-2T(d), Temporary Income Tax Regs., 52 Fed. Reg. 22768, 22775 (June 16, 1987). Therefore, no allocation of income between income attributable to the performance of services and income attributable to medical supplies is necessary in the instant case for the purpose of applying the nonaccrual-experience method of accounting.

Accordingly, we hold that petitioners' hospitals may utilize the nonaccrual-experience method of accounting for taxable years ended 1987 and 1988. We hold further that the nonaccrual-experience method is applicable to income relating to accounts receivable attributable to medical services and accounts receivable attributable to medical supplies.

To reflect the foregoing,

Appropriate orders will be issued.

UNITED STATES COURT OF APPEALS
SIXTH CIRCUIT

HOSPITAL CORPORATION OF AMERICA & SUBSIDIARIES,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 01-1810

Filed: Feb. 17, 2004

Before: MARTIN and ROGERS, Circuit Judges; EDMUNDS*, District Judge.

OPINION

ORDER

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the

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* Hon. Nancy G. Edmunds, United States District Judge for the Eastern District of Michigan, sitting by designation.

petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

INTERNAL REVENUE CODE (1987)

§ 448. Limitation on use of cash method of accounting

* * *

(d) Definitions and special rules.—For purposes of this section—

(1) Farming business.—

(A) In general.—The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).

(B) Timber and ornamental trees.—The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

(2) Qualified personal service corporation.—The term "qualified personal service corporation" means any corporation—

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly or indirectly by—

(i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),

(ii) retired employees who had performed such services for such corporation,

(iii) the estate of any individual described in clause (i) or (ii), or

(iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

(3) Tax shelter defined.—The term "tax shelter" has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof).

(4) Special rules for application of paragraph (2).—For purposes of paragraph (2)—

(A) community property laws shall be disregarded,

(B) stock held by a plan described in section 401(a) which is exempt from tax under section 501(a) shall be treated as held by an employee described in paragraph (2)(13)(i), and

(C) at the election of the common parent of an affiliated group (within the meaning of section 1504(a)), all members of such group may be treated as 1 taxpayer for purposes of paragraph (2)(B) if substantially all of the activities of all such members involve the performance of services in the same field described in paragraph (2)(A).

(5) Special rule for services.—In the case of any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person, such person shall not be required to accrue any portion of such amounts which (on the basis of experience) will not be collected. This

paragraph shall not apply to any amount if interest is required to be paid on such amount or there is any penalty for failure to timely pay such amount.

(6) Treatment of certain trusts subject to tax on unrelated business income.—For purposes of this section, a trust subject to tax under section 511(b) shall be treated as a C corporation with respect to its activities constituting an unrelated trade or business.

(7) Coordination with section 481.—In the case of any taxpayer required by this section to change its method of accounting for any taxable year—

(A) such change shall be treated as initiated by the taxpayer,

(B) such change shall be treated as made with the consent of the Secretary, and

(C) the period for taking into account the adjustments under section 481 by reason of such change—

(i) except as provided in clause (ii), shall not exceed 4 years, and

(ii) in the case of a hospital, shall be 10 years.

INTERNAL REVENUE CODE (2003)

§ 448. Limitation on use of cash method of accounting

* * *

(d) Definitions and special rules.—For purposes of this section—

(1) Farming business.—

(A) In general.—The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).

(B) Timber and ornamental trees.—The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

(2) Qualified personal service corporation.—The term "qualified personal service corporation" means any corporation—

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by—

(i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),

(ii) retired employees who had performed such services for such corporation,

(iii) the estate of any individual described in clause (i) or (ii), or

(iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

(3) Tax shelter defined.—The term "tax shelter" has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof). An S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a State agency described in section 461(i)(3)(A), but only if there is a requirement applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice.

(4) Special rules for application of paragraph (2).—For purposes of paragraph (2)—

(A) community property laws shall be disregarded,

(B) stock held by a plan described in section 401(a) which is exempt from tax under section 501(a) shall be treated as held by an employee described in paragraph (2)(B)(i), and

(C) at the election of the common parent of an affiliated group (within the meaning of section 1504(a)), all members of such group may be treated as 1 taxpayer for purposes of paragraph (2)(B) if 90 percent or more of the activities of such group involve the performance of services in the same field described in paragraph (2)(A).

(5) Special rule for certain services.—

(A) In general.—In the case of any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person, such person shall not be required to accrue any portion of such amounts which (on the basis of such person's experience) will not be collected if—

(i) such services are in fields referred to in paragraph (2)(A), or

(ii) such person meets the gross receipts test of subsection (c) for all prior taxable years.

(B) Exception.—This paragraph shall not apply to any amount if interest is required to be paid on such amount or there is any penalty for failure to timely pay such amount.

(C) Regulations.—The Secretary shall prescribe regulations to permit taxpayers to determine amounts referred to in subparagraph (A) using computations or formulas which, based on experience, accurately reflect the amount of income that will not be collected by such person. A taxpayer may adopt, or request consent of the Secretary to change to, a computation or formula that clearly reflects the taxpayer's experience. A request under the preceding sentence shall be

approved if such computation or formula clearly reflects the taxpayer's experience.

(6) Treatment of certain trusts subject to tax on unrelated business income.—For purposes of this section, a trust subject to tax under section 511(b) shall be treated as a C corporation with respect to its activities constituting an unrelated trade or business.

(7) Coordination with section 481.—In the case of any taxpayer required by this section to change its method of accounting for any taxable year—

(A) such change shall be treated as initiated by the taxpayer,

(B) such change shall be treated as made with the consent of the Secretary, and

(C) the period for taking into account the adjustments under section 481 by reason of such change—

(i) except as provided in clause (i), shall not exceed 4 years, and

(ii) in the case of a hospital, shall be 10 years.

(8) Use of related parties, etc.—The Secretary shall prescribe such regulations as may be necessary to prevent the use of related parties, pass-thru entities or intermediaries to avoid the application of this section.

FEDERAL TAX REGULATIONS (1988)

§ 1.448-2T Nonaccrual of certain amounts by service providers (temporary).

* * *

(e) Use of experience to estimate uncollectible amounts—(1) In general. In determining the portion of any amount due which, on the basis of experience, will not be collected, the formula prescribed by paragraph (e)(2) of this section shall be used by the taxpayer with respect to each separate trade or business of the taxpayer. No other method or formula may be used by a taxpayer in determining the uncollectible amounts under this section.

(2) Six-year moving average—(i) General rule. For any taxable year the uncollectible amount of a receivable is the amount which bears the same ratio to the accounts receivable outstanding at the close of the taxable year as (A) the total bad debts with respect to accounts receivable sustained during the period consisting of the taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the accounts receivable at the close of such six (or fewer) taxable years. Accounts receivable described in paragraphs (c) and (d) of this section are not taken into account in computing the ratio.

(ii) Period of less than six years. A period shorter than six years generally will be appropriate only if there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially increased. A decline in the general economic conditions in the area, which substantially increases the risk of loss, is a relevant factor in

determining whether a shorter period is appropriate. However, approval to use a shorter period will not be granted unless the taxpayer supplies specific evidence that the loans outstanding at the close of the taxable years for the shorter period requested are not comparable in nature and risk to loans outstanding at the close of the six taxable years. A substantial increase in a taxpayer's bad debt experience, is not, by itself, sufficient to justify the use of a shorter period. If approval is granted to use a shorter period, the experience for the excluded taxable years shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall be made in accordance with the applicable procedures for requesting a letter ruling and shall include a statement of the reasons such experience should be excluded. A request will not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which such approval is requested.

(iii) Special rule for new taxpayers. In the case of any current taxable year which is preceded by less than 5 taxable years, paragraph (e)(2)(i) of this section shall be applied by using the experience of the current year and the actual number of preceding taxable years. However, for this purpose, experience from preceding taxable years of a predecessor trade or business may be used in applying paragraph (e)(2)(i) of this section.

(3) Mechanics of nonaccrual-experience method. The nonaccrual-expeience method shall be applied with respect to each account receivable of the taxpayer which is eligible for such method. With respect to a particular account receivable, the taxpayer will determine, in the manner prescribed in paragraph (e) of this section, the amount of such account receivable that is not expected to

be collected. Such determination shall be made only once with respect to each account receivable, regardless of the term of such receivable. The estimated uncollectible amount shall not be recognized as gross income. Thus, the amount recognized as gross income shall be the amount that would otherwise be recognized as gross income with respect to the account receivable, less the amount which is not expected to be collected. Upon the collection of the account receivable, additional gross income shall be recognized with respect to the collection of any amount not initially expected to be collected. Similarly, no bad debt deduction under section 166 for a wholly or partially worthless account receivable shall be allowed for any amount not previously taken into income under the nonaccrual-experience method.

(4) Examples. The following examples illustrate the provisions of paragraph (e) of this section:

Example (1). X is a calendar year service provider that uses an accrual method of accounting with respect to the amounts (accounts receivable) to be received from the provision of services. X does not require the payment of interest or penalties with respect to past due accounts receivable. Assume that under this section, X adopts for taxable year 1987 the nonaccrual-experience method of accounting with respect to its accounts receivable. Further, assume that X's accounts receivable and bad debt experience with respect to those receivables for the current and five preceding taxable years is as follows:

Years	Accounts receivable	Bad debts adjusted for recoveries
1982	$ 30,000	$ 5,700
1983	40,000	7,200
1984	50,000	11,000
1985	60,000	10,200
1986	70,000	14,000
1987	80,000	16,800
	$330,000	$64,900

Thus, the ratio of the bad debts (adjusted for recoveries) for the current and five preceding taxable years to the total accounts receivable over the same period is 19.67% ($64,900/$330,000). Assume that the $80,000 of the accounts receivable outstanding as of the close of the tax year 1987 consist of sixteen separate accounts receivable. The noncollectable amount of each receivable is 19.67%. The amount of these accounts receivable and the noncollectible amount of each is as follows:

	Accounts Receivable	Applicable ratio	Uncollectible amount
1.	$5,200	.1967	$1,022.84
2.	7,300	.1967	1,435.91
3.	3,200	.1967	629.44
4.	4,300	.1967	845.81
5.	1,700	.1967	334.39
6.	4,000	.1967	786.80
7.	6,300	.1967	1,239.21
8.	8,000	.1967	1,573.60
9.	3,200	.1967	629.44
10.	6,100	.1967	1,199.87
11.	2,700	.1967	531.09
12.	8,000	.1967	1,573,60
13.	900	.1967	177.03
14.	10,000	.1967	1,967.00
15.	7,100	.1967	1,396.57
16.	2,000	.1967	393.40
	$80,000	.....	$15,736.00

For taxable year 1987, X will not accrue as income $15,736 of its total accounts receivable of $80,000.

Example (2). The facts are the same as in example (1). In 1988 the entire amount of account receivable number 8 becomes wholly worthless. Since in 1987 X did not accrue as income under the nonaccrual-experience method $1,573.60 of that account receivable, no deduction under 166 is allowable with respect to that amount of the

account receivable; a deduction of $6,426.40 under section 166 is allowable for 1988.

Example (3). The facts are the same as in example (1). In 1988 X collects, in full, account receivable number 5. Accordingly, in 1988 X must recognize additional gross income of $344.39, the amount of the account receivable that was initially considered uncollectible.

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FEDERAL TAX REGULATIONS (1989)

§ 1.448-2T Nonaccrual of certain amounts by service providers (temporary).

* * *

(e) Use of experience to estimate uncollectible amounts—(1) In general. In determining the portion of any amount due which, on the basis of experience, will not be collected, the formula prescribed by paragraph (e)(2) of this section shall be used by the taxpayer with respect to each separate trade or business of the taxpayer. No other method or formula may be used by a taxpayer in determining the uncollectible amounts under this section.

(2) Six-year moving average–(i) General rule. For any taxable year the uncollectible amount of a receivable is the amount of that receivable which bears the same ratio to the account receivable outstanding at the close of the taxable year as (A) the total bad debts (with respect to accounts receivable) sustained throughout the period consisting of the taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the accounts receivable earned throughout the entire six (or fewer) taxable year period (i.e., the total amount of sales resulting in accounts receivable) throughout the period. Accounts receivable described in paragraphs (c) and (d) of this section are not taken into account in computing the ratio.

(ii) Period of less than six years. A period shorter than six years generally will be appropriate only if there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss

is substantially increased. A decline in the general economic conditions in the area, which substantially increases the risk of loss, is a relevant factor in determining whether a shorter period is appropriate. However, approval to use a shorter period will not be granted unless the taxpayer supplies specific evidence that the loans outstanding at the close of the taxable years for the shorter period requested are not comparable in nature and risk to loans outstanding at the close of the six taxable years. A substantial increase in a taxpayer's bad debt experience, is not, by itself, sufficient to justify the use of a shorter period. If approval is granted to use a shorter period, the experience for the excluded taxable years shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall be made in accordance with the applicable procedures for requesting a letter ruling and shall include a statement of the reasons such experience should be excluded. A request will not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which such approval is requested.

(iii) Special rule for new taxpayers. In the case of any current taxable year which is preceded by less than 5 taxable years, paragraph (e)(2)(i) of this section shall be applied by using the experience of the current year and the actual number of preceding taxable years. However, for this purpose, experience from preceding taxable years of a predecessor trade or business may be used in applying paragraph (e)(2)(i) of this section.

(3) Mechanics of nonaccrual-experience method. The nonaccrual-experience method shall be applied with respect to each account receivable of the taxpayer which is eligible for such method. With respect to a particular

account receivable, the taxpayer will determine, in the manner prescribed in paragraph (e) of this section, the amount of such account receivable that is not expected to be collected. Such determination shall be made only once with respect to each account receivable, regardless of the term of such receivable. The estimated uncollectible amount shall not be recognized as gross income. Thus, the amount recognized as gross income shall be the amount that would otherwise be recognized as gross income with respect to the account receivable, less the amount which is not expected to be collected. Upon the collection of the account receivable, additional gross income shall be recognized with respect to the collection of any amount not initially expected to be collected. Similarly, no bad debt deduction under section 166 for a wholly or partially worthless account receivable shall be allowed for any amount not previously taken into income under the nonaccrual-experience method

(4) Examples. The following examples illustrate the provisions of paragraph (e) of this section:

Example (1). X is a calendar year service provider that uses an accrual method of accounting with respect to the amounts (accounts receivable) to be received from the provision of services. X does not require the payment of interest or penalties with respect to past due accounts receivable. Assume that under this section, X adopts for taxable year 1987 the nonaccrual-experience method of accounting with respect to its accounts receivable. Further, assume that X's total accounts receivable and bad debt experience for the current and five preceding taxable years is as follows:

Years	Total accounts receivable	Bad debts adjusted for recoveries
1982	$ 30,000	$ 5,700
1983	40,000	7,200
1984	50,000	11,000
1985	60,000	10,200
1986	70,000	14,000
1987	80,000	16,800
	$330,000	$64,900

Thus the ratio of the bad debts (adjusted for recoveries) for the current and five preceding taxable years to the total accounts receivable over the same period is 19.67% ($64,900/$330,000). Assume that $49,300 of the total $80,000 of accounts receivable earned throughout the taxable year 1987 are outstanding as of the close of such year. Assume further that the $49,300 of the accounts receivable outstanding as of the close of the tax year 1987 consist of 10 separate accounts receivable. The uncollectible amount of each receivable is 19.67%. The amount of these accounts receivable and the uncollectible amount of each is as follows:

	Accounts receivable	Applicable ratio	Uncollectible amount
1.	$ 5,200	.1967	$1,022.84
2.	7,300	.1967	1,435.91
3.	3,200	.1967	629.44
4.	4,300	.1967	845.81
5.	1,700	.1967	334.39
6.	4,000	.1967	786.80
7.	6,300	.1967	1,239.21
8.	8,000	.1967	1,573.60
9.	3,200	.1967	629.44
10.	6,100	.1967	1,199.87
		49,300	9,697.31

For taxable year 1987, X will not accrue as income $9,697.31 of its accounts receivable of $49,300 outstanding as of the close of the year.

Example (2). The facts are the same as in example (1). In 1988 the entire amount of account receivable number 8 becomes wholly worthless. Since in 1987 X did not accrue as income under the nonaccrual-experience method $1,573.60 of that account receivable, no deduction under section 166 is allowable with respect to that amount of the account receivable; a deduction of $6,426.40 under section 166 is allowable for 1988.

Example (3). The facts are the same as in example (1). In 1988 X collects, in full, account receivable number 5. Accordingly, in 1988 X must recognize additional gross income of $334.39, the amount of the account receivable that was initially considered uncollectible.

(5) Special rule for estimated tax. For purposes of section 6654 or 6655 only (relating to the addition to tax for underpayment of estimated tax), a taxpayer's income does not include eligible income attributable to the period before May 16, 1988. A taxpayer's eligible income is the excess (if any) of—

(i) Income (including the amount of any adjustment required under section 481(a)) computed with a bad debt experience ratio using accounts receivable earned throughout the period ending at the close of the six-year period (or other shorter period) described in paragraph (e)(2)(i) of this section, over

(ii) Income (including the amount of any adjustment required under section 481(a)) computed with a bad debt experience ratio using the year-end balances of accounts receivable over such six-year (or other shorter) period.

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